ITED STATES. CONGRESS. HOUSE. COMMITTEE ON THE JUDICIARY. SUB-
COMMITTEE ON COMMERCIAL AND ADIMISTRATIVE LAW.

# FRANCHISING RELATIONSHIP



## HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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# FRANCHISING RELATIONSHIP

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**THURSDAY, JUNE 24, 1999**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in Room 2237, Rayburn House Office Building, Hon. George W. Gekas [chairman of the subcommittee] presiding.

Present: Representatives George W. Gekas, Ed Bryant, Steve Chabot, Joe Scarborough, and Jerrold Nadler.

Staff present: Raymond V. Smietanka, Subcommittee Chief Counsel; Susan Jensen-Conklin, Counsel; James W. Harper, Counsel; Sarah Zaffina, Staff Assistant; Jon Dudas, Full Committee Staff Director and Deputy General Counsel; Daniel Freeman, Full Committee Parliamentarian-Counsel; Joseph Gibson, Full Committee Chief Counsel; Peter Levinson, Full Committee Counsel; Thomas E. Mooney, Full Committee General Counsel and Chief of Staff; Diana Schacht, Full Committee Deputy Staff Director and Chief Counsel; Perry Apelbaum, Minority General Counsel; Julian Epstein, Minority Staff Director and Chief Counsel; Sampak Garg, Minority Counsel, and David Lachmann, Minority Professional Staff Member.

## OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. GEKAS.[presiding] The hour of 10 o'clock having arrived, the committee will come to order.

As is our custom, we bang the gavel at approximately the time stated in the notices to begin such hearings, but the rules of the House maintain that we must have at least two members in order to constitute a hearing quorum. Although I am a powerful individual, I am not two individuals, and so we have to await the presence of the next member of the committee to make this official.

We have Howard Coble, of North Carolina, with us and John LaFalce, of New York, but sadly, they are not members of this committee. Their presence is well-received, but it is not adequate for the purposes of starting the hearing. So—[Laughter.]—we will now recess until the appearance of a second member of the committee.

[Recess.]

Mr. GEKAS.May I have your attention, please?

The time of the recess having expired, and still absent a quota and a quorum, the Chair has decided to open the session informally, as it were, by presenting an opening statement, and then asking our guests, our witnesses, who are members of the House, to render their statements, with the acknowledgement that the only formal part of their testimony will be their written statement which I will enter into the record after the formal proceedings begin.

With that, we welcome everyone to this hearing. It is an important one. It brings to focus a long-time association between franchisor and franchisee that has served as a bulwark of American enterprise for a long period of time.

Everyone in every community any place in the United States is acquainted with some formulation of this business arrangement, either as a consumer or as an investor or as an employee manager of some consequence. In many different ways, it touches every household that is the franchise/franchisee relationship—every household in the Nation.

We are pleased, then, to have with us, Members of Congress who have demonstrated an abiding interest in the subject matter. Jim Talent, a Member of the House, could not be with us here today, but has submitted his statement, and it will become part of the record when we begin the meeting formally.

But in the meantime, we welcome the three members who have presented themselves.

We will start with the gentleman from Arkansas, Mr. Dickey—not by reason of seniority, nor by reason that he is the biggest of the three physically, but rather because of a special request that he has made that requires him to begin and end and leave as quickly as possible.

So, without any further ado, we informally begin—we formally begin the ceremony—[Laughter.]—by acknowledging the presence now of the gentleman from New York, Mr. Nadler, the ranking minority member, who, by his presence, constitutes a hearing quorum, and everything now is of record.

With that, we recognize the gentleman from New York, if he wishes to make an opening statement.

Mr. NADLER. No—other than to say—well, I do. I want to make an opening statement—[Laughter.]—but it will be very short. [Laughter.]

Mr. GEKAS. That is what I feared.

Mr. NADLER. But it will be very short. I want to commend the chairman for scheduling this hearing today on this important topic.

Franchising fairness is an important issue, and I look forward to listening to this discussion.

And I will submit the rest of the statement for the record.

Mr. GEKAS. Without objection, it will be so accepted.

[The prepared statement of Mr. Nadler follows:]

PREPARED STATEMENT OF HON. JERROLD NADLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you, Mr. Chairman. I want to commend you for scheduling this hearing today on this important topic. Franchising is very much a part of the fabric not only of the way business is conducted today, but, franchise operations have become part of our communities. From where Americans go to buy lunch, to fix their cars, and obtain all variety of goods and services.

As franchising continues to grow, we hear persistent complaints from franchisees that what, at first appeared to be a door to the American Dream, was fraught with problems inherent to the franchising relationship. Now, I certainly don't believe that

Congress can, or should try to, guarantee success for every business. There are many reasons why businesses run into trouble. But I do believe the law should ensure that the legal relationships established and enforced by our laws are fair and open. That's what today's hearing is about.

One of our witnesses today, my colleague form New York, Mr. LaFalce, has been a genuine trail blazer in this area. As Chairman of the Small Business Committee, Mr. LaFalce held ground-breaking hearings on the rights of franchisees and introduced legislation to ensure openness, full disclosure, and fair dealings between franchisees and franchisors.

I am especially interested in hearing from today's witnesses about the extent to which the small business people who operate these franchises are given adequate information to understand their rights and responsibilities, and are helped, or hindered, as the case may be, by franchisors. I realize that this is a large industry, so I hope we can get some idea of where the system allows bad actors to take advantage of the current law to undermine what should be a successful and mutually beneficial relationship. I don't think it is necessary to condemn an entire industry for the actions of a few, but neither do I think that good conduct of the many should immunize the bad conduct of a few. Finally, as we discuss possible remedies, I would hope that the witnesses will address themselves to solutions that promote the success of these small businesses rather than stifle an industry.

I want to thank all of our witnesses and I look forward to their testimony.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Talent follows:]

PREPARED STATEMENT OF HON. JIM TALENT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

As a member of the Small Business Committee since 1993, and as its Chairman since 1997, I have personally been involved in many discussions regarding the relationships between franchisors and franchisees. Representative John LaFalce introduced legislation during the 102nd, 103rd, 104th, and 105th Congresses that would essentially rewrite the contractual relationship between these parties. Many of these bills received extensive hearings in the Small Business Committee during his tenure as Chairman and the records developed in those hearings have not demonstrated a need for additional federal regulation of the franchise relationship. The records of those hearings reflect a large amount of discord, particularly among the representatives of smaller franchisees, regarding the need for increased federal regulation of franchisor/franchisee relationships.

While many of the small business owners who testified before the Small Business Committee were proponents of legislation that increased the pre-sale disclosure requirements of franchisors, many of them were against encroachment provisions that would essentially protect the interests of larger, entrenched, multi-unit franchisees. Past franchising legislation included provisions that would bar franchisors from establishing a new franchised outlet within an "unreasonable proximity" of an existing franchise. Witnesses from both sides of the franchising debate, particularly minority franchisees, testified that encroachment provisions would decrease the growth opportunities for franchisees and reduce the entry of new franchisees into the market. Members of minority franchisee groups testified that a reduction of new franchisees would have a significant impact on women and minorities since they have traditionally been underrepresented in the ranks of franchising. This proposed encroachment stand, if included in future franchising legislation, could encourage the maintenance of the status quo in franchising and limit the number of economic opportunities available to an emerging sector of entrepreneurs.

Other concerns have been raised in the Small Business Committee hearings regarding the regulation of franchises, including the creation of a federal private right of action for violations of either the Federal Trade Commission (FTC) Franchise Rule or any state registration or disclosure law. Such a newly formed right of action, coupled with the ambiguous and undefined legal terms included in past franchising legislation, could encourage a large amount of litigation to resolve the definitions of the unidentified or poorly defined obligations of franchisors and franchisees. The provisions of the legislation discussed before the Small Business Committee could encourage franchisees to use the federal courts to settle their contractual disagreements with franchisors and substitute the judgement of a judge and jury for the business acumen of the contracting parties.

I am confident that current franchise regulation provides sufficient protection to franchisees. Both the FTC Franchise Rule and numerous individual state laws provide extensive pre-sale disclosure protection to individuals who invest in a franchise.

These required disclosures include the litigation history of the franchise; its bankruptcy history; requirements of franchisees to purchase or lease from designation courses; franchisee requirements to operate the business; and the terms of renewal, termination, or transfer of the franchise. Violations of these disclosure laws can result in civil fines, injunctions, cease-and-desist orders and compensatory damages. The previously proposed franchising legislation would simply create an intrusive and duplicative federal law and regulatory scheme.

Franchising is based on contractual relationships between franchisees and franchisors and is a private business relationship with which Congress should not interfere. Adequate safeguards exist to provide franchisees with pre-sale information, and sufficient statutory and common law remedies exist to ensure compliance with those pre-sale protections. There is serious division within the small business community over whether additional regulation would inhibit the creation of small business opportunities. Many small franchisees have raised this concern before the Small Business Committee and I hope that you will keep their concerns in mind if the opportunity arises for this Subcommittee to consider any specific legislative proposals on franchising during this Congress.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
105TH CONGRESS, COMMITTEE ON SMALL BUSINESS,
*Washington, DC, January 22, 1999.*

Hon. HENRY J. HYDE, *Chairman,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR CHAIRMAN HYDE: I am writing to express my concerns regarding H.R. 4841, which was referred to your Committee late in the 105th Congress, and which, if introduced in the 106th Congress, will likely be referred to your Committee again.

H.R. 4841 is in many ways identical to legislation introduced by Representative John LaFalce during the 102nd, 103rd, 104th and 105th Congresses, and would essentially rewrite the existing contractual relationship between franchisors and franchisees. The LaFalce bills received extensive hearings in the Small Business Committee during his tenure as Chairman and the records developed in those hearings have not demonstrated a need for additional federal regulation of the franchise relationship. The records of those hearings reflect a large amount of discord, particularly among the representatives of smaller franchisees, regarding the need for increased federal regulation of franchise relationships. At the height of their popularity during the 103rd Congress, the LaFalce bills drew only one Republican cosponsor and eleven Democratic cosponsors. The committees of jurisdiction, Energy & Commerce and Judiciary, never held hearings on the bills.

As a member of the Small Business Committee since 1993, and as its Chairman since 1997, 1 have personally been involved in many discussions of the issues raised in H.R. 4841. While many of the small business owners who testified before the Committee were proponents of legislation that increased the pre-sale disclosure requirements of franchisors, many of them were against encroachment provisions that would essentially protect the interests of larger, entrenched, multi-unit franchisees. H.R. 4841, and similar past legislation, would bar franchisors from establishing a new franchised outlet within an "unreasonable proximity" of an existing franchise. Witnesses from both sides of the franchising debate, particularly minority franchisees, testified that encroachment provisions would decrease the growth opportunities for franchises and reduce the entry of new franchisees into the market. Members of minority franchisee groups testified that a reduction of new franchises will have a significant impact on women and minorities, since they have traditionally been underrepresented in the ranks of franchising. By forcing franchisors to abide by this proposed encroachment standard, H.R. 4841 could encourage the maintenance of the status quo in franchising and limit the number of economic opportunities available to an emerging sector of entrepreneurs.

H.R. 4841 would also bar franchisors from providing incentives to encourage new participation in the franchising sector. This legislation would prohibit a franchisor from discriminating against a franchisee by imposing requirements not imposed on "similarly situated" franchisees. Blimpie's, for example, recently waived its franchise fee on 10 sandwich franchises it awarded in Atlanta's inner city. Unfortunately, this proposed legislation would have a chilling effect on such programs by leaving the determination of what is a similarly situated franchise in the hands of a court instead of allowing franchisors, to exercise their business judgment when deciding how to create new small business opportunities.

Other concerns have been raised in our hearings regarding the regulation of franchises, including the creation of a federal private right of action for violations of either the FTC Franchise Rule or any state registration or disclosure law. This newly formed right of action, coupled with H.R. 484 I's ambiguous and undefined legal terms, could encourage a large amount of litigation to resolve the definitions of the unidentified obligations of franchisors and franchisees in this bin. The provisions of this legislation could encourage franchisees to use the federal courts to settle their contractual disagreements with franchisors and substitute the judgment of a judge and jury for the business acumen of the contracting parties.

In short, there is serious division within the small business community over whether additional regulation would inhibit the creation of small business opportunities. Many small franchisees have raised this concern before the Small Business Committee and I hope that you will keep their concerns in mind if the opportunity arises for your Committee to consider any franchising legislation during the 106th Congress.

I would welcome an opportunity to discuss this vital small business issue with you and I thank you for your consideration and cooperation.

Sincerely,

JAMES M. TALENT, *Chairman.*

Mr. GEKAS.We recognize the gentleman from Arkansas, Mr. Dickey.

## STATEMENT OF HON. JAY DICKEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

Mr. DICKEY. Thank you, Mr. Chairman and Mr. Nadler. I want to tell you first from whence I come.

I have been a franchisee in three different operations—all in the food service, mainly Taco Bell. From December 1985 until 1998, I was a Taco Bell franchisee, and most of my comments will relate to my experience in that regard. I have also had a Dandras franchise, as well as a Baskin-Ribbons franchise, so these things are not uncommon to me, as far as my experience. I am also an attorney, and that is going to present one part of the problems that I have had in dealing with franchisors.

I want to say at the outset that there wasn't any way for myself to get into the business of franchising or employing people or making profits from food enterprises without there being a franchisor. The experience that they brought to the areas that I wanted to get into was invaluable. I was a fairly good franchisee; I followed what they said. But there is a natural friction that exists between a franchisor and a franchisee on a daily basis, basically. The franchisor is saying, "You are not investing enough in the business for the future." And the franchisee is saying to the franchisor, "You are neglecting us in the studying of our operations and in the advice that you are supposed to give in the supervision."

I want to center in on, in talking about this, though, in one respect, and that is the legality of the relationship. I will give you one example. When I really got into the franchise business in a big way was when I owned a piece of property and Taco Bell wanted to place a store there. And they did. I was the landlord, and they wanted to expand, and because of the expansion, they asked me if I wanted to be a franchisee, and so I said, "Yes."

I, then, as an attorney, read the franchise agreement. It was totally one-sided; there is no question about it. I knew that I liked the people; I liked their reputation; and I felt like it could go in Pine Bluff, Arkansas; and it did. A very successful operation came out of it, and a relationship, a good relationship, came out of it.

But one provision I want to just bring to this committee's attention was the provision that said that any dispute that we might have—now there were others that were far-reaching and overreaching, as I might say, but this one, in particular, I think will point out some of the problems. It said that if there was any dispute in this matter, that the dispute will be settled not only in the geographical jurisdiction of California, but with the laws of California.

Now here I was, the sole practitioner in Pine Bluff, Arkansas, trying to run a business, and if I had any dispute at all, that I was giving venue and jurisdiction to California. That, in essence, meant that any dispute that might come up, I was going to be faced with attorney's fees that would—and delays—that would be, of course, not to my advantage, but also, that I would have to learn California law or hire a lawyer out there and go through the delays of that particular State's judicial system.

I thought about that a long time. And I decided, well, I am going to go forward with it. And, thank goodness, we didn't have any disputes. But even the fact that that is in there means that every time that I want to stand up and say what is right for my customers in Pine Bluff, Arkansas, I was thinking, well, all they have to do is—we would just have this referred to a court in California, and I am—it is over. It is over for me.

And I think that a franchise agreement should have, in this respect—and I just mentioned it—more of a emphasis on what is good for the customer, and I don't think that was good for the customer because it put me back on my heels. It would put other people back on their heels. And, remember, I was a lawyer at the time.

Now you might say—some people might say who are lawyers, "Well, the fact that you are a lawyer gives you—attributes to you a greater awareness." And you can't say, "Well, I didn't understand that provision." I didn't have that as a defense. Someone else might could do it and say, "I can't afford to hire a lawyer; I'll just sign this agreement, and I just hope it works out." And when they get to court or they get to an interpretation, they say, "Well, I didn't understand that, and I didn't have a lawyer available." I didn't have that available. So I was sitting there totally exposed to the whims of the franchisor if, in fact, a different administration might come.

And that is the other part of this, is that you are sitting across the table, and you happen to like somebody, and you deal with them—and the negotiations went on for a long time back in 1985. And I felt that I was with some people who I could deal with. But they switch all the time. Taco Bell is merged with Pizza Hut and Kentucky Fried Chicken, and they had people moving in and out all the time. So I was stationary, and I was looking across the table, and this was a moving—you might say, a moving set of characters.

And I don't think that that is the right thing. I think if we get a fairness, a balance, in this thing—now remember, the franchisor has the ideas; they have had the experience. They, if you will, have polled the customers and found out what is good and what is not good, and their ideas and their innovations and everything are absolutely essential. But it is not just one-sided.

The other side is that the people on the ground level have got to build a relationship with customers, have got to know them by names, and when things go wrong, give them replacements, and go to their houses and say, "Here is—I understand that you didn't get at the drive-thru this amount." And so you have to do all those things. And we are out there just knitting the relationships one by one, customer by customer.

And I don't—in the scheme of things, when it comes down to it, I can understand both sides. But the balance, I think, goes to the fact that we need a better circumstance with the franchise agreements and the legality of the relationship of the franchisees and the franchisors, and have a little bit more respect to the guy who has to meet the payroll and who has—he has to win. You know what you have to understand in the food business; you have got to win the customer over every time. You can't say, "Well, 7 out of 10 is good." You know, in baseball, 300 percent is fine. In the food service, 300 percent is losing. It doesn't do any good. You have got to be 100 percent sometimes.

And I know as a franchisee, we have tried to do that, and we have tried to have people smiling with name tags and everything else, and then the franchisor comes in and just says, "We want you to open until 3 o'clock in the morning." And you are sitting there thinking, "Well, I have got to go to California to dispute this thing,"—you see—"if I want to do it." Or, "We want you to stay open 24 hours." Or, "We want you to bring your prices down to 49 cents for a Taco."—when you are selling them for 79 cents before that.

It is a scary thing. I had to borrow more money than I was worth when I got into the business.

Well, you are looking at me like I am talking too long. Mr. Chairman, are you with me in this thing?

Don't you say a word. [Laughter.]

Mr. GEKAS.Are you asking for me to lend you money? [Laughter.]

Mr. DICKEY. I would know better than that. [Laughter.]

I would know better than that. [Laughter.]

And don't think for a minute I would want to owe you any money.

Mr. GEKAS.Touche.

Mr. DICKEY. All right; all right.

Well, I know—the reason I stopped there is I can see—I can sense that I am going into this thing in probably too much detail. But I think it is a question of whether or not we are going to honor what the franchisees do and they have to go through.

Some of the franchisors had been in the franchisee business—some of the people, some of the officers, and everything else—and they understood the constant battle and the having to win each transaction. But I don't think the legal documents reflect that. And, why should they? We don't have much—franchisees don't have much leverage in this deal.

Now, I am a conservative, and I don't believe that government needs to come into these things, so I am in a conflict. I don't—it would be absolutely horrible. It would be a disaster to all franchise business if the Federal Government drafted the franchise agreement. There is no question about that. It would just be a disaster; things would just stop. There is nothing that requires a franchisor for going out and adopting a franchisee as their agents for giving a product to the rest of the country or the world; there is not. And if our government gets in there, it is going to be like throwing sand in the relationship.

But some attention needs to be given, and there needs to be some give and take in this thing. And I want you all to be sure to consider carefully this bill, and consider the fact that we are trying to serve the customers. And, are these relationships good for the customers? I think on balance, there is a problem with it because of the leverage and the weight that the franchisor has in the relationship—in particular, the legal entanglements.

Thank you, Mr. Chairman.

Mr. GEKAS.We are very grateful for your testimony, and we will excuse you if you have other commitments.

Mr. DICKEY. Yes, sir, unless there is a question.

Mr. GEKAS.I just wanted to state one thing, that the gentleman from New York is about to violate, I believe—[Laughter.]—and that is that we normally do not submit our colleagues in the first panel of these hearings to any examination by the members of the committee, but rather allow them to make their statements and exit, so——

Mr. DICKEY. Well, do I need to raise my right hand?

Mr. GEKAS.So you are about to ask to breach that?

Mr. NADLER. Not really. [Laughter.]

Mr. GEKAS.All right.

Mr. NADLER. I want to say one thing to Representative Dickey and one thing before we introduce Congressman LaFalce.

I simply wanted to say, Jay, I wish you had testified longer. I was fascinated by what you had to say, by your testimony and——

Mr. GEKAS.I think you did fine. [Laughter.]

Mr. NADLER. I think he did excellent. I—[Laughter.]

No, that is what I am saying. [Laughter.]

I was fascinated by what you had to say; I was very interested in it. And seeing it from an actual experience point of view, I think you really put your finger on the—what is apparently an inequity of standing, in effect, between the franchisor and the franchisee, which really underlies all the complaints that we have received.

And I understand your reluctance to say that obviously the Federal Government shouldn't write the franchise agreement—nor could it, for obvious reasons. But maybe, given what you said, we should set certain broad standards for franchise agreements. For example, saying that you can't, or only under certain circumstances can you demand that all things be litigated in a California court. New York court, certainly; but a California court, I am not——

Mr. DICKEY. Oh, no, no.

Mr. NADLER. So I just wanted to say thank you for that testimony.

And before Representative LaFalce is introduced, I simply want to extend a special welcome to him as a colleague from New York, and also to note that we are—where we are in consideration of any legislation in this area, largely because of Congressman LaFalce's trailblazing efforts in his formal capacity as the chairman of the Small Business Administration—not Small Business Administration, Small Business Committee—in holding extensive hearings in this field a few Congresses ago, and in drafting what I think was the first major legislation in the area, so I want to thank you for your efforts on which we will build.

Mr. GEKAS. I want to thank the——

Mr. DICKEY. Could I say one more thing, Mr. Chairman?

I want to add to that about Mr. LaFalce.

Can I—just stay quiet a second.

Mr. GEKAS. I am waiting for——

Mr. DICKEY. Okay.

Mr. GEKAS. I am waiting for your exit.

Mr. DICKEY. Okay. [Laughter.]

Mr. GEKAS. No, that is all right; proceed.

Mr. DICKEY. Mr. LaFalce was the chairman of my committee when I first came here, and he has been steadfast in his concern for the franchisee, and I want to add to what Mr. Nadler said.

Thank you, Mr. Chairman.

Mr. GEKAS. Before we recognize the gentleman from New York, I want to indicate that the gentleman from Tennessee, Mr. Bryant, is also present for these proceedings.

Does the gentleman wish to——

Mr. BRYANT. Mr. Chairman, I wanted to say something before Mr. Dickey left, how much I appreciated his testimony today, and I apologize for being a little bit late to hear all of it. But just in general concern, I would like to keep as open a mind as possible about this, but I am reminded in this situation, with all due respect to my friends who hold franchises—and I am sure many in the audience perhaps do that—it is like running for Congress, when we complain that we don't like the hours; we hate to raise money, and we hate to do these kinds of things. My wife always tells me that no one held a gun to my head and made me run.

And in many ways, that parallels this relationship of a private contract—and as my distinguished colleague from Arkansas mentioned—we all are reluctant I think to get involved at the Federal level in a private contract. And certainly when people close deals like this transaction like this, they have attorneys—and should have attorneys—to represent them and should be familiar with all the requirements of that contract. And certainly I assume there are other options if you don't like Kentucky Fried franchise agreement. Perhaps Ms. Winters might work better or something like it—perhaps negotiations can occur, but again, I want to listen to this, because I do hear and respect a great deal of people like Jay Dickey and other members who have come in here with this.

But after listening to my colleague from New York, I did want to sort of lay out the other side a little bit, too, and I know you will appreciate that, too.

Thank you.

Mr. GEKAS. We thank the gentleman.

We now belatedly turn to the gentleman from New York, Congressman LaFalce.

## STATEMENT OF HON. JOHN J. LAFALCE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. LAFALCE. Thank you very much, Mr. Chairman, and Mr. Nadler, and Mr. Bryant, and I appreciate the kind comments that you did make.

Listening to Mr. Dickey brought back so many memories, because of the hearings that I had during the early part of the 1990's as chairman of the Small Business Committee on the entire issue of franchising.

Mr. Dickey pointed out some of the difficulties, you know, entering into a contract as an attorney when he knew that he couldn't negotiate that contract. It was take it or leave it, and basically a contract of adhesion, and he would have to abide by California law and litigate in California if need be. Well, that is better than if the firm were bought by somebody in Great Britain or Japan and having to litigate it in Great Britain or Japan, but that, too, does obtain in some instances.

And in some instances, of course, litigation is precluded by the contract itself. As a matter of fact, I believe the automobile dealers are concerned right now because of the difficulties they are having to go into the court because of the mandatory arbitration provisions—but that is a separate issue.

With respect to the issue that you raised, Mr. Bryant, you know, people are free to enter into the contracts; nobody is going to force them. Well, that is sort of like a worker saying to an employer—or an employer saying to a worker, "Well if you don't want to work on my terms and conditions, you don't have to work."

Well, Congress intervened—not in establishing what the contract should be, but in passing the Wagner Act, we legislated a framework for fair bargaining between labor and management. And I think that it would behove us if we considered, given the fact that we are talking about interstate commerce—I mean, this is not something that is done within the State of Kentucky or Pennsylvania or New York. This is something that is done internationally today, and certainly is not interstate. And certainly, if you enter into a contract in Arkansas, and they are applying California law, you have one law for the whole country. It happens to be California law, whether you are in Arkansas or Kentucky or New York, California law is applying. And so if we could fashion some type of a law which would just bring about fair principles, I think that would be, you know, a very, very wise thing to do.

Also, I want to point out the importance of this hearing. I am unaware of any hearing that has been held in Congress on the issue of franchising in the House of Representatives since mine, and that goes back to the early-1990's. In 1990, I issued a report entitled, "Franchising in the U.S. Economy: Prospects and Problems." There are tremendous prospects—tremendous prospects, nationally and internationally. And there are tremendous problems, too. And the artistry, it seems to me, is maximizing the potential of franchising, which is tremendous, and minimizing the problems, which are tremendous, too, and we ought not to underestimate the——

Mr. GEKAS.Without objection, if the gentleman so desires——

Mr. LAFALCE. Sure.

Mr. GEKAS. [continuing]. We will make that report a part of this record as well.

Mr. LAFALCE. Okay.

Well, many factors contribute to these problems, gentlemen. Four strike me as particularly important.

First, with very few exception, such as auto and gasoline dealers, there are no Federal laws governing either the sale or operation of franchise systems, which, as I pointed out, clearly operate interstate and most often multi-or internationally. The only regulatory procedure at the Federal level, the Federal Trade Commission's franchise disclosure rule, is very outdated and inadequately enforced. Even the FTC says they do not have the capacity to enforce it. Only a handful of States have laws or regulations governing franchise sales and practices, and most of those have largely deferred to the Federal Government, to the FTC, for enforcement. And the FTC says they lack the capacity for enforcement.

Secondly, 40 years of litigation by franchisors has unfortunately left the role of the franchisee largely undefined for purposes of Federal and State law. Franchisees are not employees for purposes of employee benefits or protections. They are not independent agents for purposes of Uniform Commercial Code and contract law. And that is something else, too. People can enter into contracts; they don't have to; you are not forced to. But that didn't prevent virtually every State in the union, I believe, from adopting the Uniform Commercial Code. I mean you establish basic precepts, basic principles. That is what we need to do here, too.

Franchisees are neither consumers, customers, nor investors for purposes of consumer, investor, and fiduciary protections. So, as a result, basic legal standards applicable in all other business relationships—basic. Now what am I talking about? Concepts such as good faith, good cause, duty of competence and due care, and fiduciary responsibility, typically are not applicable.

Third, franchisees confront the tremendous imbalance in franchise contracts that bind them to accept virtually all actions and decisions of their franchisor, no matter how arbitrary or abusive. The contracts have become 50-to 70-page documents that outline in great detail the duties, obligations, and restrictions on franchisees, while remaining almost silent on the obligations and promised services of franchisors. These contracts are nonnegotiable in almost every single instance. And franchisors have vigorously enforced these contracts with the help of courts that have most often refused to consider anything beyond the terms of the contract.

And, fourth, the problems of franchise contracts are compounded by the fact that they are written by franchisors to preempt almost every possible legal challenge. Procedural devices are routinely employed to bar legal actions, to deny protections in State laws, and to make litigation, inconvenient, costly, and, thus, prohibitive for most franchisees.

You heard Mr. Dickey. Indemnification clauses are written so broadly as to preclude almost any possible legal claim. As a former chairman of the American Bar Association's Franchise Forum once told the Small Business Committee, indemnification provisions in franchise contracts are drafted so broadly as to protect franchisors, even, "For the franchisor's gross negligence, wanton recklessness, and intentional misconduct." Now that was the chairman of the American Bar Association's Franchise Committee.

During the conversation before the hearing, someone else pointed out a difficulty, too. Even if you didn't have the difficulties with the contract, itself, contacts expire, and the ability to renew that contract is pretty much in the hands exclusively of the franchisor. Now that is a tremendous wedge; that is a tremendous wedge. And so a franchisee is very, very reluctant to contest a franchisor, because even if the franchisee were to contest the franchisor successfully, there is a very strong possibility or likelihood that the franchisor might simply not permit the franchisee to renew the contract. This is a serious concern, too.

Mr. Coble, Mr. Nadler, and some others have introduced in this Congress basically bills that I have introduced in past Congresses. Most of the important provisions are contained therein. I am very grateful to them for the leadership they have had—they have shown, especially as members of the committee.

I am going to shortly introduce a new version of the Federal Fair Franchise Practices Act. What I am going to try to do is target it much more specifically than my previous proposals to the problems I outline in my testimony, the most basic elementary things, make it as simple as possible. It will be drafted to minimize the legal disadvantages of franchise ownership—first, by clarifying existing law to provide basic standards of fair conduct for franchise relationships. Secondly, by enhancing available private remedies to permit franchisees to protect their legitimate financial interests in a court of law.

Briefly, my bill will clarify that five standards of conduct that are widely recognized in common law for most business and professional relationships would also apply in contractually-defined franchise relationships.

These would include, first, a duty of good faith. It would require that all parties to a franchise agreement act in good faith in the performance and enforcement of a contract. There is absolutely no reason why this basic principle of the Uniform Commercial Code which applies to all other business relationships should not apply to franchises.

Secondly, a duty of due care. It would impose on franchisors a duty to exercise due care and reasonable standards of competence in establishing and operating its franchise system. This is a basic precept of the restatement of torts that applies to all other business professionals. It requires that they have both the qualifications and the capacity to perform the services they advertise or promise. Again, there is absolutely no good reason this should not be adopted.

Now Mr. Dickey pointed out that he was dealing with somebody across the table he had confidence in, and he had to rely on that person across the table for advertising. He had to rely on that person across the table for counsel, and advice, and instructions, and what have you. But then that person across the table is no longer with the company, or the company is sold. The company is merged or acquired, very often by, you know, a firm in Asia, Europe, wherever it might be. And, then, is the standard of due care going to be adhered to? Well, when it is not in the contract, it is not applied by the courts, there is no way to enforce it.

Further, when we think of franchise relationships, we tend to think of the biggies. Mr. Dickey mentioned Taco Bell; he mentioned some others, you know, McDonald's, et cetera; that is terrific; those are the big ones. It is going to be easier to have due care exercised by the larger ones. But there are literally thousands of very, very small franchise operations that you have never heard of, and they very often do not provide the management, counsel, and assistance that a franchisee requires and reasonably is entitled to.

Third, a good cause standard. The legislation would apply the common law principle of good cause to franchise terminations. No legitimate purpose is served when a franchisor can arbitrarily terminate a franchisee's contract, and, thus, his livelihood, without any proven breach of contract or any opportunity to cure any alleged breach or default.

Fourth, a fiduciary obligation. We should subject franchisors to a fiduciary standard in the limited circumstance where the franchisor requires that it handle basic financial or accounting services for its franchisees or administers pooled advertising funds to which it requires franchisees to contribute. Now this is a basic common law protection. If the franchisor says, "I will handle the financial; I will handle the accounting; I will handle the advertising with your money." Fine, but hold them at least to a fiduciary relationship.

And, fifth, a right of association. The bill would require the franchisors to recognize the right of franchisees to form independent association and require a good faith standard in all undertakings between the franchisor and the association. Independent associations need not be adversarial, that can provide information sharing, training, joint purchasing, and other functions that are vital to a successful franchise system.

I am not going to go on because of the time constraints that you and I have, but I really think that enacting proposals similar to Mr. Coble's, Mr. Nadler's, my own, that define the legal relationship between franchisors and franchisees would constitute landmark positive legislation. And travel across America, and you see, for the most part, franchised operations. Go to any mall in America. You know 90 percent of your operations are franchise operations in malls. This landmark legislation would be similar to the Wagner Act of the 1930's, that helped structure labor management and relations.

I believe that franchise legislation is as necessary today as labor management legislation was in the 1930's, if we want to bring fairness and balance to this very important growing sector of the United States and world economy.

And I thank you very much for the opportunity to address the committee.

[The prepared statement of Mr. LaFalce follows:]

PREPARED STATEMENT OF HON. JOHN J. LAFALCE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Chairman Gekas, Ranking Member Nadler, Members of the Subcommittee, I appreciate the opportunity to appear before the Subcommittee this morning and commend the Chairman for organizing today's hearing to examine the important issues of franchise business relationships and franchise regulation.

In 1990, while serving as Chairman of the Committee on Small Business, I released the House of Representatives' first comprehensive study of franchising. This study formed the background for hearings that I conducted on franchising issues over the succeeding five years. These hearings, in turn, provided the basis for franchising bills which I introduced in 1991 and 1992, and reintroduced as the Federal Fair Franchise Practices Act in the three succeeding Congresses. I was pleased to see that the legislation introduced last Fall by Mr. Coble, Mr. Conyers, Mr. Nadler and other Members of this Committee included all the key proposals of my earlier legislation.

The Small Business Committee's hearings on franchising were initially intended to document the growing trend and importance of franchising in our nation's economy and in new small business formation. That trend and importance has increased significantly in the ensuing decade. My subsequent hearings focused more on the legal and operational aspects of franchise business relationships. Those hearings sought to answer the questions of whether franchises provide investors with a greater chance for long-term business ownership and success? Whether franchisees possess ownership rights that are commensurate with independent businesses? And whether current law and regulation are adequate to protect the investment and ownership rights of franchise business owners?

The answer to these questions was generally "no". The Committee's inquiry encouraged a number of independent studies showing, for the first time, that a franchisee's chances for success is statistically similar to that of independent business start-ups. We also found, most disturbingly, that franchisees enjoy few of the legal rights and protections available in Federal and state law for other private business owners. And we found that franchisees have limited legal recourse to protect their livelihood and their investment in courts of law.

While many factors contribute to these problems, four strike me as particularly important. *First*, with very few exceptions, such as auto and gasoline dealers, there are no Federal laws governing either the sale or operation of franchise systems—which clearly operate on an inter-state and, often, a multi-national basis. The only regulatory procedure at the Federal level, the Federal Trade Commission's franchise disclosure rule, is outdated and inadequately enforced. Only a handful of states have laws or regulations governing franchise sales and practices, and most of these have largely deferred to the Federal government for enforcement.

*Second*, forty years of successful litigation by franchisors has left the role of the franchisee largely undefined for purposes of federal and state law. They are not employees for purposes of employee benefits or protections, nor are they independent agents for purposes of the uniform commercial code and contract law. They are neither consumers, customers nor investors for purposes of consumer, investor and fiduciary protections. As a result, basic legal standards applicable in all other business relationships—*concepts such as good faith, good cause, duty of competence and due care, and fiduciary responsibility*—typically are not applicable to franchisees.

*Third*, franchisees confront a tremendous imbalance in franchise contracts that bind them to accept virtually all actions and decisions of their franchisor no matter how arbitrary or abusive. These contracts have become 50- to 70-page documents that outline in great detail the duties, obligations and restrictions on franchisees, while remaining almost silent on the obligations and promised services of franchisors. And franchisors have vigorously enforced these contracts with the help of courts that have most often refused to consider anything beyond the strict terms of the contract.

*Fourth*, the problems of franchise contracts are compounded by the fact that they are written by franchisors to preempt every possible legal challenge. Procedural devices are routinely employed to bar legal actions, to deny protections in state laws and to make litigation inconvenient, costly and, thus, prohibitive for most franchisees. Indemnification clauses are written so broadly as to preclude almost any possible legal claim. As a former chairman of the American Bar Association's Franchise Forum once told the Small Business Committee, indemnification provisions in franchise contracts are drafted so broadly as to protect franchisors even "for the franchisor's gross negligence, wanton recklessness and intentional misconduct."

In short, Mr. Chairman, a growing number of American business people must routinely sign away their basic rights and legal remedies as citizens and as business owners in order to purchase a franchise. This is unfair and it is unacceptable.

*I will shortly introduce* a new version of my Federal Fair Franchise Practices Act legislation that will be targeted, more specifically than my previous proposals, to the problems I outline in my testimony. Its purpose is to minimize the legal disadvantages of franchise ownership—*First*, by clarifying existing law to provide basic standards of fair conduct for franchise relationships; *Second*, by enhancing available private remedies to permit franchisees to protect their legitimate financial interests in a court of law.

Briefly, my legislation clarifies that five standards of conduct that are widely recognized in common law for most business and professional relationships would also apply in contractually defined franchise relationships. These include—

- *(1) Duty of Good Faith:* It requires that *all parties* to a franchise agreement act in good faith in the performance and enforcement of the contract. There is absolutely no reason why this basic principle of the Uniform Commercial Code, which applies to all other business relationships, should not apply to franchises.
- *(2) Duty of Due Care:* It would impose on franchisors a duty to exercise due care and reasonable standards of competence in establishing and operating its franchise system. This basic precept of the Restatement (second) of Torts applies to all other business professionals and requires that they have both the qualifications and the capacity to perform the services they advertise or promise. Again, there is absolutely no good reason this should not be adopted.
- *(3) Good Cause Standard:* The legislation would apply the common law principle of good cause to franchise terminations. No legitimate purpose is served when a franchisor can arbitrarily terminate a franchisee's contract, and thus his livelihood, without any proven breach of contract or any opportunity to cure any alleged breach or default.
- *(4) Fiduciary Obligation:* It would subject franchisors to a fiduciary standard in the limited circumstances where the franchisor requires that it handle basic financial or accounting services for its franchisees or administers pooled advertising funds to which it requires franchisees to contribute. This is a basic common law protection.
- *(5) Right of Association:* The bill requires franchisors to recognize the right of franchisees to form independent associations and requires a good faith standard in all undertakings between the franchisor and the association. Independent associations need not be adversarial, and can provide information sharing, training, joint purchasing and other functions that are vital to successful franchise systems.

In addition, the bill provides a private right of action for franchisees to initiate actions in federal court for alleged violations of these standards of conduct and for violations of the disclosure requirements in the FTC's Franchise Rule (something the FTC has sought for nearly 20 years). It would also nullify provisions in future franchise contracts that are intended to limit or exempt franchisors from liability under these standards or that seek to bar or limit a franchisee's rights to bring legal actions.

Contrary to what some franchisors will tell you, this legislation does not constitute government regulation of franchising. On the contrary, it simply identifies standards of fair conduct and legal redress in current law and clarifies their application to franchise relationships. These are *minimal* standards of conduct for an industry of this size and importance. But they will have a tremendous impact in helping to restore basic fairness to franchising.

Mr. Chairman, on numerous occasions since 1990 I have said that enacting proposals that define the legal relationship between franchisors and franchisees would constitute landmark legislation. In much the same way as the Wagner Act helped structure labor-management relations for the industrial economy of the 1930s, I believe this legislation can bring balance and fairness to the huge franchising sector of our services-based economy.

Thank you again for the opportunity to address the Subcommittee.

Mr. GEKAS.We thank the gentleman.

The written statement of the gentleman will be accepted for the record. And he, if he wishes, may exit.

Mr. LAFALCE. Thank you.

Mr. GEKAS.And we now turn to the gentleman from North Carolina, the individual at whose request these proceedings are being conducted here today. The "Prince of Pinehurst," as I call him—[Laughter.]—is a member of the Judiciary Committee and chairman of one of its important subcommittees, and he has been in consultation with this Chair on this subject for a good period of time. So his interest in the subject matter goes without question, and we turn to him now for his statement.

## STATEMENT OF HON. HOWARD COBLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Mr. COBLE. Mr. Chairman, I will warmly embrace the title "Prince of Pinehurst." Those who resided in the village of Pinehurst may reject that, however. [Laughter.]

Mr. Chairman, I thank you and Mr. Nadler and Mr. Bryant for being here today. I appreciate those in the audience as well.

Unlike Mr. Dickey, I have never been a franchisee. Not unlike Mr. Dickey, I am a conservative, ideologically, and do not believe that the Federal Government should extend its tentacles into every potential problem that arises. When problems do arise, however, that require the attention of the Congress and the Federal Government, I think action should be forthcoming, and this may well be the case here.

We are talking, Mr. Chairman, about pursing the American dream. Now I am glad to see my friends—and I do have friends in the International Franchise Association in the audience today. And I was somewhat disappointed because you will not be hearing from one of the IFA's official representatives who has lobbied against this bill, and did so very properly. I think the IFA has chosen its witness, an individual who I am sure will do a good job in presenting his case, but I think he represents only a small segment of the franchising industry.

If the subcommittee will indulge me for a minute, I would like to give you a little background on the investment a franchisee must make when it comes to opening a franchise business. Now these are general ranges, Mr. Chairman, but I think appropriate. A typical individual looking to invest in a franchise operation must pay the parent corporation an initial licensing fee ranging, I am told, from $3,000 to $100,000. They also must invest another approximately $100,000 to several million, I am told, in equipment, signs, supplies. They may spend another $12,000 to $30,000 for opening inventory. And speaking of supplies, Mr. Chairman, and, gentlemen, I am bothered by many instances where sole vendors are identified, and the franchisees are directed to purchase supplies and ingredients from only one vendor, whereby they could probably purchase it for far less from other vendors, if competition were allowed.

In addition to these investments, the small business franchisee may have to pay rent to the parent corporation. At the same time—Mr. Dickey mentioned this—they must be prepared to provide benefits, meet a payroll for their employees prior to earning one dime in sales. Once open for business, the small business person pays a percentage of gross sales, not net sales, to the franchisor. Typically, these payments range between 5 and 12 percent and could extend as high as 20 percent. In addition to all this, a mandatory payment into a pooled advertising fund is often required, and this is usually about 3 percent.

After hearing all this, I am sure you are wondering why anyone would invest in a franchise business. Not only is it incredibly expensive, but with this expense comes various corporate strings. For instance, where you may locate or build your outlet, where you may buy supplies, which I mentioned earlier, or what price you must charge for the goods that you are dispensing, and to whom you may sell your investment, and on what terms, just to name a few.

When speaking to this point of franchise power, you don't have to look any further than the horse's mouth. A major franchisor indicated in a recent press release that to alleviate its debt load and boost stagnant sales, the company would be shifting more burden onto its franchisees. Did the franchisees have any say in this decision? Probably not. Nonetheless, the franchisor has the unilateral power and the right to dump or to transfer its burden onto the franchisee.

Now, Mr. Chairman, as you know, and perhaps Mr. Nadler and Mr. Bryant as well, at the conclusion of the 105th Congress, Mr. Coburn, Congressman Conyers, and I introduced legislation to establish a more level playing field in the business relationship between corporations that sell franchises and the small businessmen and women who invest in them.

Earlier this year, I met with several representatives of the International Franchise Association to discuss their concerns with our legislation. During this meeting, I asked the IFA to analysis our bill section by section and explain to me in writing, if they would why any single provision of the bill would be harmful or damaging to franchising.

Some weeks later—and I appreciate the fact that they did require—I think it was about 10 weeks later, which tells me that they were thorough and deliberate in examining the same, I received a response from them.

Well, if the only problems that exist are those that are contained in the two pages that I received from the IFA representative, it indicates to me that we may well be ready for a compromise here. I don't see that there is that much difference. Now this may be revealed further as the day progresses, Mr. Chairman.

I think we all recognize that the goals of the franchisor/franchisee relationship are fundamentally economic, where the objective of each party is to make money; Capitalism, at its best, one would think. Unfortunately, that is where the mutuality oftentimes ends. In the context of a means to an end, the interest of the franchisee and franchisor are not always identical. For instance, because the parent corporations collect royalties on sales, not profits, it is in the corporate franchisors interest to open more outlets, even if at the expense of the existing franchisee.

Human nature tells me, Mr. Chairman, and, gentlemen, that there are "bad apples" in every bunch, and this applies to franchisors and franchisees. I am not suggesting to you all today that all franchisors are bad, and that all franchisees are choir boys. I am sure there are good and bad on each. In fact, I just saw some representatives from Krispy Kreme, a good franchisor, headquartered in North Carolina, and there are other good franchisors here as well. But nonetheless, the recent increases in the franchising-related litigation and complaints to the Federal Trade Commission lead me to believe that the Congress should examine this what I call a problem.

And I thank you all, Mr. Chairman, for conducting this hearing. I appreciate you letting me testify, and without objection, I would like to enter into the record, in addition to my written statement, the letter that I received from IFA spelling out their problems with the proposed legislation.

Mr. GEKAS. That will be very helpful. We accept them for the record, without objection.

[The information referred to follows:]

INTERNATIONAL FRANCHISE ASSOCIATION (IFA),
*New York, NY, March 18, 1999.*

Hon. HOWARD COBLE,
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR CONGRESSMAN COBLE: Thank you for the invitation to follow up on our discussion with you regarding our concerns about H.R. 4841's impact on franchising.

Three primary concerns have guided the franchisor, franchisee and supplier members of the International Franchise Association (IFA) in the decision to continue our opposition to federal franchise relationship legislation. These primary concerns were the basis for IFA's opposition to identical franchise relationship proposals introduced by Rep. John LaFalce (D–NY) in previous Congress.

1. Franchising is a bastion of economic opportunity and empowerment for women and minorities. Franchise relationship legislation will discourage franchise growth and, as a result, have a disproportionate impact on women and minority entrepreneurs.
2. H.R. 4841 would severely damage the majority of franchisors, who themselves are small businesses. 72% of franchisors complying with state and federal disclosure requirements are estimated to have less than $2 million in franchise royalty revenue. Many duties and obligations contained in the provisions of H.R. 4841 are undefined or ambiguous. These terms—"unreasonable proximity," "skill or knowledge," "material provision," "due care," and "legitimate business reason," to name just a few—would create confusion and uncertainty in franchise relationships and lead to increased litigation between franchisees and franchisors.
3. Franchisors, franchisees and consultants to the field agree that it is virtually impossible to craft a "one size fits all" solution to the wide variety of franchise business practices involving companies operating in 70 different industries. For example, there is no common "relationship" legislation that can apply both to systems that charge no royalties (because a product sale constitutes the only franchisor income) and also to those systems entirely dependent on franchise fees and royalties for franchisor income.

In addition to these general concerns, we are troubled by specific provisions in H.R. 4841, especially those that would limit the ability of franchisors and franchisee advisory councils to enforce system standards. Among the key advantages of franchise businesses are a proven business concept: a marketing and operating plan; a recognized name and trademark; and consumer recognition and loyalty. In order for a franchise system to protect the investment of their franchisees, the franchise system must also protect the value and integrity the brand, which requires the franchise system to maintain and enforce standards in the operation of the franchise. If system standards cannot be enforced, substandard operations will reduce the system to its lowest common denominator and jeopardize the investment of all franchisees in the system.

For example, the transfer section would permit transfer of a franchise for a period of up to one year to certain individuals who did not meet the franchisor's "then current qualifications" for obtaining a franchise. This would wreak havoc on a franchise system, which would have to endure a year of substandard operations of such an individual before being permitted to enforce its system standards. In the meantime, existing franchisees—and the value of the brand—would suffer the consequences.

The encroachment section would produce similar results by denying the opportunity to existing or new franchisees to open units in "unreasonable proximity" to existing units. "Unreasonable proximity" (like many other provisions in the bill) would be defined by the courts, and fails to consider demographic and geographic distinctions. The quick-service restaurant that operates in Manhattan (as in New York City) is governed by the same restrictions as the quick-service restaurant in Manhattan, Kansas. Two totally different demographic and geographic markets, governed by the same "one-size-fits all" relationship provisions. These are just two examples of the ambiguous and undefined terms contained in H.R. 4841 that will encourage litigation and create uncertainty and confusion in franchise relationships.

IFA members believe current presale disclosure requirements strike the right balance between legitimate consumer protection and stifling over-regulation. "Investigating before investing" is made easy, since franchise disclosure law requires that franchisors provide prospective franchisees with a list of the names and telephone numbers of current and former franchisees, along with 20 other specific items about the investment.

IFA and its members believe that franchising works because entrepreneurs benefit from the flexibility to structure franchise relationships in the manner that works best for their product, service or industry. Relationship laws like H.R. 4841, and identical LaFalce bills introduced in prior Congresses, destroy the flexibility vital to an entrepreneurial economy. That is one reason that IFA and its members have supported efforts—like the Small Business Regulatory Enforcement Fairness Act and similar measures—intended to reduce government regulation of small businesses. We hope you will agree that the marketplace still provides the best opportunity to create successful and productive business relationships.

IFA continues to emphasize the role of franchisees in our organization and decision making process. You and other members of Congress should know that IFA member franchisees do not support additional government regulation of franchising and oppose H.R. 4841. We hope that after reviewing the concerns of our members—franchisees, franchisors and suppliers—you will reconsider your position.

If you have any questions or if we can provide you with additional information, please let me know.

Sincerely,

MATTHEW R. SHAY, *Vice President and Chief Counsel.*

[The prepared statement of Coble follows:]

PREPARED STATEMENT OF HON. HOWARD COBLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

Chairman Gekas, Ranking Member Nadler, members of the subcommittee, thank you for allowing me to testify this morning. I don't think the Subcommittee could choose a more worthwhile endeavor than protecting the freedom to pursue the American Dream by leveling the playing field for thousands of small business franchisees across this country.

While I'm glad to see my good friends from the International Franchise Association in the audience today, I must admit that I am very disappointed this committee will not be hearing from one of IFA's official representatives who have been aggressively lobbying the Hill against franchise legislation. While I recognize that IFA has chosen to speak through one of its association members, this individual—who I'm certain will do an outstanding job representing IFA's position—only represents a small segment of the franchising industry.

If the committee will indulge me for a moment, I would like to give you a little background on the investment a franchisee must make when opening a franchised business. While these are general ranges on investment, a typical individual looking to invest in a franchise operation must pay the parent corporation an initial licensing fee ranging from $3,000 to $100,000. They also must invest another $100,000 to several million dollars in equipment, signs, and supplies; then they may spend another $12,000 to $30,000 for opening inventory. Other miscellaneous opening expenses of as much as $50,000 may also be necessary. As you can see, the total price tag for one franchised unit can be as high as several million dollars. On top of this initial investment, the small business franchisee may have to pay rent to the parent corporation. At the same time, they must also be prepared to provide benefits and meet a payroll for their employees prior to earning one dime in sales. Once open for business, the small business person pays a percentage of gross sales, not net sales, to the franchisor. Typically these payments range between 5 and 12 percent, but can reach as high as 20 percent. On top of all this, a mandatory payment into a pooled advertising fund is often required and this is usually about 3 percent.

After hearing this, I am sure you are wondering why anyone would invest in a franchised business. Not only is it incredibly expensive but with this expense comes various corporate strings. For instance, where you may locate or build your outlet; where you must buy your supplies; what price you must charge for your goods and/or services; and to whom you may sell your investment and on what terms to name a few.

When speaking to this point of franchisor power and abuse, you don't have to look any further than the horse's mouth. A major franchisor indicated in a recent press release that "to alleviate its debt load and boost stagnant sales", the company would be shifting more burden onto its franchisees. Did the franchisees have a say in this decision? Of course not. Nonetheless, the franchisor had the unilateral power and right to dump its burden onto the franchisees.

As you know, Mr. Chairman, at the end of the 105th Congress, Congressman Conyers and I introduced legislation to establish a more level playing field in the business relationship between corporations that sell franchises and the small businessmen and women who invest in them. Earlier this year, I met with several representatives of the International Franchise Association to discuss their concerns with our legislation. During this meeting, I asked IFA to analyze our bill, section-by-section, and explain to me in writing why any single provision of the bill would be harmful to franchising. Two and one-half months later, I received a two-page letter—which I would like to submit for the record—from IFA outlining its problems. Well my friends, I am here to tell you that if these are the only problems IFA has with the bill—and I must assume these are since I asked for a comprehensive analysis of our legislation—we are much closer to passing franchise legislation than anyone realizes.

I think we all recognize that the goals of the franchisor/franchisee relationship are fundamentally economic where the objective of each party is to make money. Capitalism at its best one would think. Unfortunately, that's where the mutuality ends. In the context of a means to an end, the interests of the franchisee and franchisor aren't always the same. For instance, because the parent corporations collect royalties on sales, not profits, it's in the corporate franchisor's interest to open more outlets, even if it's at the expense of an existing franchisee.

Human nature tells us that there are bad apples in every bunch, and this applies to both franchisors and franchisees. All franchisors are not bad actors, in fact, there are some who support our legislation. By the same token, all franchisees are not choir boys. Nonetheless, the recent increases in franchising-related litigation and complaints to the Federal Trade Commission lead me to believe that Congress must examine this matter.

As a conservative Republican who supports smaller government and less regulation, many people have asked me why I support franchise legislation. First of all, the legislation which we introduced is not about bigger government and more regulation—it's about protecting freedom. The freedom for small business franchisees to contract fairly, honestly, and without fear of retribution. Secondly, the Constitution provides Congress with the authority to regulate interstate commerce which Congress has already done for some franchisees by enacting the Petroleum Marketers Act and the Auto Dealers Day in Court Act. The time has come to apply these same standards to all franchise business relationships.

In closing, I think we all would agree that small businesses are the heart and soul of our nation's economy, however, it is important to recognize that many of these small business opportunities would not have been available without the assistance of the franchisor community. After all, they provide franchisees with a recognized brand name, advertising and marketing knowledge and support, and training.

I hope the testimony we hear today will help us craft a bill that is fair and balanced. We are not seeking to penalize anyone. We only seek to bring some order and sanity to a segment of our economy which is growing and may be growing out of control.

Again, thank you for allowing me to testify, and I look forward to working with the committee on this issue that is important to so many of our nation's small business operators.

Mr. GEKAS.We thank the gentleman from Pinehurst, and we ask him to contact Payne Stewart on our behalf—[Laughter.]—to see if we can form a——

Mr. COBLE. Mr. Chairman, for the record, Pinehurst is in my district, but I do not reside within the confounds. I can't afford to live in Pinehurst. [Laughter.]

Mr. GEKAS.All right. We thank the gentleman.

We now are prepared to impanel the next set of witnesses who are Susan Kezios, who is the founder and president of the American Franchisee Association, the Nation's largest trade association dedicated to representing the interests of small business franchisees. The association's 9,000 members own more than 22,000 outlets in at least 60 separate industries. Ms. Kezios, herself, is a former franchisee and eventually became vice president of marketing for a franchisor. In addition, Ms. Kezios owns her own business, Women In Franchising, which she started in 1987 to assist women with their franchise development needs. Through her business, Ms. Kezios has worked with the U.S. Department of Commerce's Minority Business Development Agency and the U.S. Small Business Administration's Office of Advocacy. Ms. Kezios participated in the 1995 White House Conference on Small Business, where she espoused legal and constitutional rights for franchisees.

She is joined at the table by Michael F. Adler, the president, chairman, and chief executive officer of Moto-Photo, Inc., one of the leading franchisors of 1-hour photo finishing and portrait studios, with 419 stores located in the United States and elsewhere. He appears today on behalf of the International Franchise Association, a nonprofit trade organization founded in 1960, whose members operate more than 30,000 franchised small businesses. In addition to his business responsibilities, Mr. Adler is actively involved in his community. He helped found and thereafter chaired Dayton, Ohio's, citywide development corporation and serves as chairman of Dayton's Venture Capital Committee. He is also director of the Dayton Art Institute and the National Center for Industrial Competitiveness. Mr. Adler holds degrees in finance and law from Ohio State University.

Third on our first panel is Patrick James Leddy, Jr., who has owned and operated a Baskin-Robbins 31 Flavors franchise, located in Newhall, California, for 13 years. He is also a 26-year veteran firefighter with the Los Angeles City Fire Department. Before joining that fire department, Mr. Leddy served 4 years in the United States Air Force during the war with and in Vietnam.

Arleen Goodman is welcomed to the panel. Over the course of her 20-year career in independent business, Arleen Goodman operated a charter bus enterprise, a tourism management firm, and has been a franchisee for Kampgrounds of America, a national campground chain. Ms. Goodman currently is president of Goodman and Company, an advisory firm for business acquisitions, development, and strategic alliances. She is also a principal in SportsNet, a company that associates professional athletes with franchising businesses. In addition to these credentials, Ms. Goodman served as chair of the Tennessee delegation to the 1995 White House Conference on Small Business. She currently serves on the board of the International Franchise Association and is a trustee of the association's education foundation. Ms. Goodman was the first woman elected president of the Kampgrounds of America's owner's association and was a founding member of the American Franchisee Association. She has been named by Nashville Life Magazine as 1 of the 25 most influential women in Nashville.

Darrell Dunafon is with us from Jefferson City, Missouri, and currently as a franchisee with Sandella's. He was previously a franchisee with Taco Bell and was executive chairman of the International Association of Taco Bell Franchisees. He opened his first Taco Bell restaurant in 1974.

Lawrence "Doc" Cohen—we won't ask—[Laughter.] Doc is the founder and former CEO of Deblan Corporation, a leading franchise of the Great American Cookie Company. Over the course of his association with this company, he opened 35 locations that eventually employed more than 300 men and women. As a testament to his accomplishments, he has received several awards, including being named as the "Franchisee of the Decade in 1993." He has the distinction of being the first and only franchisee in the world to have earned the designation of certified franchise executive which is given by the International Franchise Association. In addition, Mr. Cohen is a trustee for the association's educational foundation and chairs the association's Franchisee Advisory Council. In addition to these endeavors, Mr. Cohen is involved in various community activities including the annual Easter Seals Telethon and Leukemia Society Board of Trustees.

We welcome the panel. We delineate the formal ground rules to the effect that each of the written statements of the members of the panel will be accepted, without objection, for the record. Secondly, the testimony which should constitute a summary of the written statement, will be restricted as best we can restrict without being rude to 5 minutes for each statement. Because of the number of witnesses we have, that is a necessity. We will begin in the order in which the panelists were announced with Ms. Kezios who is recognized for 5 minutes.

## STATEMENT OF SUSAN KEZIOS, PRESIDENT, AMERICAN FRANCHISEE ASSOCIATION, CHICAGO, IL

Ms. KEZIOS. Thank you, Mr. Chairman, members of the committee. Thank you for the opportunity to present the position of the American Franchisee Association regarding the state of franchised business relationships in the United States today.

Despite the highly visible role that franchising plays within our economy, there are fundamental flaws in its basic structure, and, unfortunately, some franchisors take advantage of these flaws.

When you look at this chart, you'll see from these advertisements that the American dream of owning your own business is the lure that pulls many individuals to investigate franchising. Companies offering franchises for sale entice the buyer with promises of owning their own cruise business, their own printing business, their own golf business, their own training business. The analogy is made that owning a franchise is like purchasing a home in that the investor will be building equity in him or herself by buying the franchise. The reality in most cases is you are not owning your own business, it is more like renting an apartment.

The reality hits home once franchisees try to realize the long-term equity they thought they were building. For example, the franchisee buys the franchise. He agrees in his initial contract that when he is going to sell the franchise, he has three potential buyers: the franchisor, another franchisee within the system, or an outside third party. During the term of his contract, the franchisor arbitrarily changes the internal policy. The franchisee all of a sudden cannot sell to an outside third party, effectively cutting that man's value of his franchise by one-third. So, due to an arbitrary and unilateral decision of his franchisor, and due to no action or inaction of his own, this man loses one-third of the equity in his business.

What is even worse is that franchisors justify this kind of abuse by claiming that presale disclosure in lengthy, unintelligible legal prospectus makes any abusive trade practice like this lawful and proper. This and other situations that you are going to hear about occur because there is no existing baseline standard of conduct for franchisors and franchisees to abide by after the sale.

You have already heard there is no Federal requirement for both parties to abide by the familiar common law duty of good faith in their dealings with each other, no duty of due care that the franchisor must show to its franchisees, no limited fiduciary duty when the franchisor handles its franchisees' money in bookkeeping or accounting functions or pooled advertising funds.

You have also heard mention of the Federal Trade Commission's trade regulation rule on franchising and business opportunity ventures. We feel that the FTC rule is totally inadequate in dealing with current franchisee issues. The FTC, despite their staff's good intentions, is truly a "paper tiger." The FTC—if you turn your attention to this chart—requires that each franchisor attach to its disclosure document a front cover page—as you see here—which states, in part, "To protect you we have required your franchisor to give you this information. We haven't checked it; we don't know if it is correct." The cover page then goes on to deputize the prospective franchisee, someone who is not a business owner yet, with, "If you find anything you think may be wrong or anything important that has been left out, you should let us know about it. It may be against the law." This despite consistent rulings in all Federal court circuits that franchisees cannot sue to enforce the FTC's franchise rule.

Most Americans don't rob banks, yet we still have laws against bank robbery. Most issuers and underwriters of corporate securities don't lie and cheat, yet we still have laws against securities fraud. And even if most or many franchisors do not abuse their position and power, and even if some franchisees are large, wealthy and sophisticated investors, we still need effective Federal standards to discourage franchise abuses.

The problems of franchisees are not isolated. [illegible] Franchisee Association [illegible] 40 percent of the franchisees surveyed [illegible] ful relationship with their franchisor [illegible] would not advise others to [illegible] the problems experienced by current franchisees [illegible] use of power, and that is why we are here.

There is no freedom of contract when one party [illegible] transaction can arbitrarily and unilaterally [illegible] for profit at the expense of the other party. [illegible] contract when one party can dictate [illegible] terms of the contract. [illegible] party can disavow [illegible] dealing, and due care.

The American Franchisee Association [illegible] minimum standards [illegible] store freedom of contract [illegible] franchising as a [illegible]

Thank you.

[The prepared statement of Ms. Kezios follows:]

PREPARED STATEMENT OF SUSAN KEZIOS, PRESIDENT, AMERICAN FRANCHISEE ASSOCIATION, CHICAGO, IL

Chairman Gekas and Members of the Subcomittee, my name is Susan P. Kezios. I am President of the American Franchisee Association (AFA). The American Franchisee Association is the largest trade association in the U.S. solely representing the interests of small business franchisees. We have over 9,000 individual members who own approximately 22,000 franchised businesses in 60 different industries.

I thank you for the opportunity to present our position to the committee regarding the status of franchised business relationships in the U.S. today.

Despite the highly visible role that franchising plays within our economy, there are fundamental flaws in its basic structure. Some franchisors take advantage of those flaws.

Let me show you what someone confronts when they investigate purchasing a franchise. As you can see by these advertisements, the American dream of owning your own business is the lure that pulls many individuals to investigate franchising as a means of small business ownership. Companies offering franchises for sale entice the buyer with promises of owning their "own cruise business, printing business, consulting business, training business." The analogy is made first through these advertisements and then in conversations with franchise salespeople that owning a franchise is like purchasing a home in that the investor will be building equity in him or herself by buying the franchise. The reality in most cases is you're not owning your own business, its more like renting an apartment.

That reality hits home once the franchisees try to realize the long-term equity they thought they were building once they try to transfer or sell the franchise.

Franchisees are possibly the only small business owners in the world who cannot sell what they own. At some point a franchisee may choose to sell her franchise to a new owner. Most franchise systems require in the event of transfer that the buyer must sign the "then-current" franchise agreement, meaning that the current franchisee cannot sell the remaining years on his agreement at the financial and operational terms originally agreed to with the franchisor. Because the "then- current" franchise agreement is likely to have different financial obligations for the transferee (a windfall gain to the franchisor) this requirement automatically drives down the value of the current franchisee's business, lowering the purchase price and devaluing the assets. Neither of these agreements is negotiated; they are drafted unilaterally by the franchisor's lawyers.

I recently talked with a fast food franchisee about the transfer of one of his locations. He told me that when he bought the franchise he signed a contract that stated that his franchisor must approve the new buyer—to which he didn't object. He recognized there were three potential buyers for his outlet; the franchisor, another franchisee or an outside party. So he signed the contract, learned how to run his business and became known as a good operator within the system.

His contract also stated that to be in compliance and not in default, he may have to adhere to the franchisor's operations manual(s) and other company policies as the franchisor might change them from time to time. During the term of his contract, the franchisor changed their internal policy regarding to whom he could sell his franchises. He no longer could sell his franchise to an outside party, effectively cutting the value of his franchise by 1/3rd. This man bought the franchise, learned how to run the business, became a good operator within the system, was building equity in his business and assets and through no action of his own lost 1/3rd of his equity in his business by an arbitrary and unilateral decision of his franchisor.

Another example to illustrate the "renting an apartment" analogy: Many franchise systems require franchisees to purchase products solely from the franchisor or from suppliers designated by the franchisor. Even though identical goods are often available from competitive sources no allowance is given to purchase from competitive sources even if quality standards are upheld. That means the small business franchisees in your district are buying products and services to sell to the consuming public from outside of your district and most probably outside of your state from high cost vendors.

Many franchise corporations routinely and unnecessarily restrain trade between competing vendors. Their franchisees are severely restricted in their ability to shop for and negotiate the best prices on conforming products and supplies. This drives up costs for franchisees and prices for consumers. And federal courts just as routinely hold that these restrictive trade practices do not violate the anti-trust laws.

How has franchising evolved to this point? Two reasons: One, as franchising has grown from its humble beginnings in the 1950's, so too have franchise agreements evolved between franchisor and franchisee. From a simple hand-shake with the Colonel in the 1950's the franchise agreements of today have developed to the point where other than the provisions relating to the use of the trademark, use of the proprietary information and the payment of fees, almost every other provision of the agreement seems to have some aspect of controlling, trapping or defeating the franchisee.

Franchisees are governed solely by lengthy and totally one-sided contracts drafted by the franchisors' attorneys. The vast disparity in economic power and bargaining strength enables the franchisor to determine arbitrarily the rules by which the two parties conduct their business affairs post-sale. These rules are incorporated into the franchise agreement which the franchisor prepares unilaterally for the franchisee's signature. What is even worse is that franchisors then justify their own abuses by claiming that pre-sale disclosure—in lengthy, unintelligible, legal prospectuses—makes any abusive trade practice lawful and proper.

The second reason these situations occur is because there is no existing baseline standard of conduct for franchisors and franchisees to abide by after the franchise sale has been made. There is no federal requirement for franchisors and franchisees to abide by the familiar common law duty of good faith in their dealings with each other; no duty of due care that the franchisor must show to its franchisees; no limited fiduciary duty when the franchisor handles its franchisees' money in bookkeeping or accounting functions or pooled advertising funds. The current scheme of the Federal Trade Commission's (FTC) Trade Regulation Rule on Franchising and Business Opportunity Ventures and the hodgepodge of state disclosure laws are totally inadequate in dealing with current franchisee issues.

The real problem with the FTC's franchise rule is that it gives the appearance of government oversight without any enforcement. The FTC, despite its staff's good intentions, is truly a paper tiger. The FTC requires each franchisor to attach to its disclosure document a front cover page as you see here, which states in part, "To protect you, we've required your franchisor to give you this information. We haven't checked it and don't know if its correct." The cover page then deputizes the prospective franchisee, someone who is not a business owner yet with: "If you find anything you think may be wrong or anything important that's been left out, you should let us know about it. It may be against the law." This despite consistent rulings in all federal court circuits that franchisees cannot sue to enforce the FTC's franchise rule.

The absence of any minimum standards of conduct in a multi-billion dollar industry should be a serious concern for us all. Franchising is the least scrutinized investment market in the United States today. Securities, lending, banking, leasing, the professions, the purchase of commodities—each of these multi-billion dollar markets has minimum standards of conduct set by federal law. Securities issuers cannot gain access to the public to sell securities without meeting minimum financial standards under both federal and state laws. By federal law securities issuers can only sell stock to suitable investors—those who have the experience and financial resources to afford the risks associated with the investment. The securities industry recognizes the fiduciary relationship between brokers and buyers of securities. No such minimum standards exist for franchise companies. Many franchise chains would be unable to sell stock on the U.S. markets, yet they are able to solicit investors for franchises at $150,000 and more. And these same franchise chains are unwilling to accept any enforceable standards of conduct.

Most Americans don't rob banks, yet we still have laws against bank robbery. Most issuers and underwriters of corporate securities don't lie and cheat, yet we still have laws against securities fraud. And even if many or even most franchisors do not abuse their position and power, and even if some franchisees are large and sophisticated investors, we still need effective federal standards to discourage franchise abuses.

Our opponents will say that the stories you have heard regarding the problems in franchising are "merely anecdotal. They are not widespread. They are just a few disgruntled, unsuccessful franchisees asking the government to intervene on their behalf." Attached to my testimony is a copy of the American Franchisee Association's (AFA) Franchisee Satisfaction Survey. Forty percent of the franchisees surveyed feel they have an unsuccessful relationship with their franchisor, have been encroached upon by their franchisor, have been threatened by a representative of the franchisor and are/have been in a dispute with their franchisor. Fifty-five percent of responding franchisees would not advise others to join their franchise systems. This sounds like more than mere "anecdote" to me.

Most of the problems experienced by current franchisees derive from a misuse of power. That is why we are here seeking changes that will level the playing field.

There is no freedom to contract when one party to a business transaction can arbitrarily and unilaterally increase its opportunity for profit at the expense of the other party.

There is no freedom to contract when one party can arbitrarily and unilaterally change the terms of the contract.

There is no freedom to contract when one party can disavow ordinary common law duties of good faith, fair dealing and due care.

The American Franchisee Association asks that you establish minimum standards of conduct for the franchise industry and restore freedom of contract for small business people who choose franchising as a way of doing business in the United States.

Thank you.

AMERICAN FRANCHISEE ASSOCIATION

FRANCHISEE SATISFACTION SURVEY REPORT—05/08/96

Prepared by: Frank H. Wadsworth, Ph.D., Wayne Jones, Ph.D., Indiana University Southeast

MANAGEMENT SUMMARY

The general findings from the data analysis of the franchisee satisfaction survey indicate several negative aspects of the business. Overall, 77.4% of responding franchisees have a significant amount (more than four years) of experience with their franchise system. Although franchisees surveyed appear to feel that their franchise is financially successful, this feeling of financial success is expected since the majority of responding franchisees have passed the breakeven point and have profited somewhat from their franchise. However, achieved profit levels are not perceived to be equivalent to franchisor projected profit margins.

For example, a related issue to financial success is the feeling by 46.3% of responding franchisees that discounting and promotional activities are forced on them by the franchisor and that they have suffered on average a 9.8% decline in profits because of these activities. Further, a majority of franchisees also feel that they purchase goods and services from franchisors that are inflated in price. Fifty percent of franchisees estimated three-year failure rates in their franchise system to be greater than 13.75%.

Relational issues between franchisees and franchisors are even less positive. Approximately forty percent of franchisees report that they have an unsuccessful relationship with their franchisor, have been encroached upon by their franchisor, have been threatened by a representative of the franchisor, and are/have been in a dispute with their franchisor.

Overall, support services from franchisors are viewed negatively by franchisees. About two-thirds of the responding franchisees sense that they are not getting the full value of their advertising fees and that support services from franchisors are inadequate.

Sixty-three percent of the respondents came from three industries: convenience store, mailing services and. fast food. Ninety percent of respondents came from 12 industries: convenience store, mailing services, fast food, quick oil change, cleaning services, vision care, lodging, temporary personnel, hoteliers, home fashions, resorts and retailing (electronics).

In conclusion, responding franchisees are generally dissatisfied with their franchise as relates to support received, are divided on satisfaction with the relationship 'with the franchisor and appear to be just moderately satisfied with their franchise on a financial basis.

INTRODUCTION

*Background*

The American Franchisee Association (AFA) is a trade association representing the interests of 6,969 member franchisees who own over 14,000 franchised outlets. The mission of the AFA is to represent the interests of franchisees to the media, the public and government, improve the business climate for franchising and to protect the economic investments of franchisees. The AFA is interested in determining the satisfaction of its membership with their franchising operations and franchisors.

*Research Design*

The sample consists of 470 responses to a franchisee satisfaction survey included in the *AFA Quarterly*, a newsletter for AFA members. Data were collected over s nine month period from April 1, 1993 to January 31, 1994. Survey forms were returned to the AFA offices by mail or facsimile transmission. Data analysis consisted of response frequency reports, univariate statistics and two-way tabulations.

Survey respondents have on average 9.7 years of experience with their franchise system with half of the respondents having eight or more years in the franchise system. Franchise system tenure ranged from three months to 35 years. The average number of franchise outlets owned by each respondent was 2.8. Sixty-three percent of responding franchisees own a single outlet. An additional 28% of responding franchisees own between two and five outlets. Nine percent of responding franchisees own six or more stores.

DETAILED FINDINGS

*Financial issues*

Respondents were asked several questions about financial issues related to their franchises. The first question asked respondents for their level of financial satisfaction with their franchise. Just seventeen percent of respondents feel their franchisee operation is very successful financially. Almost 54 percent of franchisees feel their franchisee operation is somewhat successful financially, while an additional 20.4% feel their franchisee is somewhat unsuccessful financially. Approximately nine percent of franchisees feel their franchise operation is very unsuccessful financially.

Two questions asked franchisees whether or not their franchise had broken even and if so, when break-even status was achieved. Eighty percent of responding franchisees have broken even. On average break-even status was achieved during the thirty-second month of business by responding franchisees. Sixty-six percent of franchisees reported breaking even in the first or second year of operation. Seventy-four percent of responding franchisees have been in business more than two years and have broken even. Therefore, survey respondents could be characterized as franchisees who have managed to survive and remained in business a sufficient length of time to profit from their franchised outlet.

Questions about profit levels of franchises elicited the following responses. Of franchisees that have survived and remain in business, 79.4% of these franchisees have profited from their franchise. However, while franchisees may have profited at some point, profits are perceived as declining due to many factors such as encroachment and discounted pricing. Sixty-two percent have not earned the franchisor projected profit level while just 3 8 percent of franchisees have earned the franchisor projected profit.

Questions about discounting/promotional activities revealed the following among responding franchisees. Forty-six percent of franchisees feel that they are forced by their franchisor to discount their products or services. Eighty-nine percent of franchisees who feel that they are forced to discount their products or services perceive that discounting/ promotional activity has increased in the last few years. A mere seven percent of franchisees who feel they are forced to discount have experienced profit increases, while 92.7% believe their profits have decreased as a result of discounting/promotional activities. The average perceived profit increase is 8.4% and the average perceived profit decrease is 9.8%. Overall, franchisees sense that their profit margins have decreased by 6.4% because of discounting/promotional activities.

Questions about inflated prices for goods and services revealed that 57.4% of franchisees purchase goods or services from their franchisors that they feel have inflated prices. Fifty-one percent of those respondents report having to purchase these inflated priced products and services from their franchisors.

Franchisee estimates of the failure rate of franchisees in their system over a three year period ranged from zero to 100 percent. The average failure rate estimate was 19.2% for a three year period, with fifty percent of franchisees estimated three-year failure rates to be greater than 13.75%. Only twenty-five percent of responding franchisees estimated failure rates to be less than five percent.

There is a strong statistical relationship between perceived financial success and advising others to join ones franchise system. Survey data showed 58% of franchisees who perceive their franchise to be financially successful would advise joining their franchise system while only 16.3% of franchisees who perceive their franchise to be financially unsuccessful would advise joining the same system. No relationship between perceived franchise financial success and the number of outlets owned was revealed in the survey responses.

*Relational issues*

Several questions regarding the quality of the franchisee-franchisor relationship were asked of survey respondents. Over forty-three percent of franchisees feel their relationship with their franchisor is unsuccessful. Additionally, fifty-five percent of franchisees would not advise others to join their franchise system.

A few questions were asked about whether the franchisor had ever encroached upon the franchisee's business. Forty percent of franchisees felt that the franchisor had encroached upon their business in some way. Of this group, 90.5% felt that their profits had suffered because of franchisor encroachment. The average amount of perceived decline in profit due to franchisor encroachment was 18.9%, with 81% reporting losses of between 9% and 40+%. Of franchisees feeling encroached upon and perceiving that profits had suffered because of the encroachment, only 2.9% indicated they were compensated for their losses by their franchisor.

Ten percent of franchisees feel they have been coerced into purchasing an outlet nearby because the franchisor threatened to sell it to another franchisee if they did not purchase the outlet. Fifteen percent of franchisees have tried to end their relationship with their franchisor only to find that it was impossible to get out of the system.

Two questions dealt with franchisor threats toward franchisees. Forty percent of franchisees reported having been threatened by a representative of their franchisor. Threatened franchisees have received many types of threats (percentages add to more than 100 percent because of multiple responses). Two percent of franchisees reporting having been threatened by a franchisor representative have been threatened physically. Fifty-eight percent of franchisor-threatened franchisees have been verbally threatened, and 44.8% have been threatened financially. Having a franchisor threaten to terminate a franchisee agreement, not renew the agreement or prevent the franchisee from expanding has been experienced by 57.3% of franchisor-threatened franchisees. Twenty-four percent have received threats or pressure from the franchisor when trying to set up an independent franchisee association, forcing them to abandon their attempt to establish the association.

Disputes with franchisors were the topic of two questions. Of the respondents, 30.1% are currently in a dispute with their franchisor, and 11% of franchisees have sued their franchisor.

*Support service issues*

Advertising fees issues comprised one part of the support service questions asked in the survey. Thirty-two percent of franchisees feel they are getting the full value of the advertising fees they pay franchisors. Sixty-eight percent of franchisees do not feel they are getting the full value of their advertising fees. Franchisees who felt they had not received the full value of their advertising fees felt this way for a number of reasons (percentages add to more than 100 percent because of multiple responses). Having no say in where or how advertising fees are spent was indicated by 40.9% of those franchisees as a reason for their attitude. Fifty-one percent of franchisees feel they don't receive the full value of their advertising dollars because advertising benefits the chain image, not their particular store or local market. Thirty-eight percent of franchisees feel that not all of their advertising fees are spent on advertising.

General support service questions revealed the following attitudes among franchisees. Over sixty-one percent of franchisees surveyed perceived support services provided by franchisors as inadequate. They cite a number of reasons (percentages add to more than 100 percent because of multiple responses). A full forty percent of franchisees perceive that the support services promised when they signed their franchise agreement are not provided. Fifty-eight percent of franchisees feel that support services have diminished over time. Eighteen percent of franchisees sense that the number of support services has remained the same but that the quality of those services is lower. Contracts that do not obligate the franchisor to provide much in the way of support services are held by 32.8% of franchisees. Support services from franchisors were perceived as adequate by 3 83% of franchisees.

LIMITATIONS

No research study is without limitations and this survey is no exception. Although none of these limitations are critical for reporting results to AFA members, the use of this data for purposes such as expert testimony is cautioned for the following reasons. First, responses do not come from a random sample of AFA members and it cannot be determined if respondents are representative of all franchise systems. Second, data was collected over a long period (approximately nine months) and the environment for franchisees may have changed from the beginning to the end of the data collection period. Third, responses to questions such as "Did you earn what you expected you would based on the information your franchisor gave you?" would provide richer data if we knew what year the franchisee began, what the franchisor's projected profit margin was upon entry into the system and then were able to track the franchisee's profit margins with income data (financial statements). Fourth, though this is a satisfaction survey, critics may state that some of the questions are not worded in "neutral" terms; this may have affected the tone of the responses. Some people might argue that the first three questions are the only unbiased satisfaction questions on the survey. Fifth, responses to questions such as, "If you don't feel you are getting the full values of advertising fees you pay your franchisor, why not? (#15)," are likely to be overstated because of the limited number of alternates. Some franchisees may have a reason for their attitude about the advertising fees value, however, because their specific reason is not listed as an alternate, they will pick one of the listed choices which results in an overstatement of responses.

## CONCLUSIONS

Responding franchisees are a mature group, with half of the respondents having more than eight years of experience with their franchise system. In addition, a large percentage of the mature franchisees (those with more than 32 months of experience with their franchise system) own franchises that have broken even and produced a profit for the owner. Overall, it appears that the majority of mature franchisees feel that their franchise is financially successful. A significantly smaller percent of less mature franchisees (those having less than 32 months experience with their franchisee system) perceive financial success with their franchisee system (57.2% less mature operators versus 72.6% more mature).

The franchisee/franchisor relationship issues are perceived as even less successful. The percent of franchisees that feel the relationship is not successful or very unsuccessful is substantial (43.2%). Relational success depends on the maturity of the franchisee. A larger percent of less mature franchisees (those having less than 32 months experience with their franchise system) feel their relationship with their franchisor is successful than more mature franchisees (59.4% versus 56.2%). The large percent of franchisees that sense that their franchisor has encroached upon their business and that have been threatened by a franchisor representative is alarming. It is interesting that 42% of franchisees have sued or are currently in a dispute with their franchisor.

## RECOMMENDATIONS

Recommendations are made to increase the reliability and validity of the conclusions based on the survey findings. For a formal study, the AFA should first commission an individual or agency (not the AFA or franchisors' offices) to conduct a recurring survey so responses are returned to an 'unbiased' location and personnel, decrease the time period. for the study and make it constant for all respondents, and increase the professionalism of the research and data collection in an effort to increase the defensibility of the conclusions in testimony, articles, press releases, etc.

Second, develop a reliable and valid measure of franchisee satisfaction for use in survey research. As part of the measure development process, the domain and parameters of franchisee satisfaction, negative and positive should be defined. Questions from each dimension of franchisee satisfaction should be included in the satisfaction measure to increase the validity of survey results. Although the current study was conducted in a professional manner, future use of research in expert testimony, articles, etc. is likely to require the collection of data in the most professional manner possible before research results are deemed reliable and valid.

63-852 D-00-2

## Appendix A

*Frequency Tables and Univariate Statistics for Franchisee Satisfaction Survey*

Question # 1: Overall would you consider your franchise operation successful in terms of financial return?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Very successful | 1 | 80 | 17.2 | 17.2 |
| Somewhat successful | 2 | 250 | 53.6 | 70.8 |
| Somewhat unsuccessful | 3 | 95 | 20.4 | 91.2 |
| Very unsuccessful | 4 | 41 | 8.8 | 100 |
| | | 4 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Mean | | 2.208 | | |
| Median | | 2 | | |
| Standard error | | 0.038 | | |

Question # 2: Overall would you consider your franchise operation successful in terms of your relationship with, and assistance provided by, your franchisor?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Very successful | 1 | 44 | 9.5 | 9.5 |
| Somewhat successful | 2 | 220 | 47.3 | 56.8 |
| Somewhat unsuccessful | 3 | 117 | 25.2 | 81.9 |
| Very unsuccessful | 4 | 84 | 18.1 | 100 |
| | | 5 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Mean | | 2.518 | | |
| Median | | 2 | | |
| Standard error | | 0.042 | | |

Question # 3: Would you advise other to join your franchise system?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 198 | 44.8 | 44.8 |
| No | 2 | 244 | 55.2 | 100 |
| | | 28 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Mean | | 1.552 | | |
| Median | | 2 | | |
| Standard error | | 0.024 | | |

Question # 4: How many years have you been in your franchise system?

| Value label | Frequency | Percent | Cumulative % |
|---|---|---|---|
| Two years or less | 47 | 10 | 10 |
| More than two years to four years | 73 | 15.6 | 25.6 |
| More than four years to six years | 79 | 16.9 | 42.5 |
| More than six years to ten years | 97 | 20.7 | 63.2 |
| More than ten years to fifteen years | 83 | 17.8 | 81 |
| More than fifteen years to twenty years | 47 | 10 | 91 |
| More than twenty years to twenty-five years | 28 | 6 | 97 |
| More than twenty-five years to thirty-five years | 14 | 3 | 100 |
| | 2 | Missing | |
| Total | 470 | 100 | |
| | | | |
| Mean | 9.765 | | |
| Median | 8 | | |
| Standard error | 0.327 | | |

Question # 5: How many stores or outlets do you own?

| Value label | Frequency | Percent | Cumulative % |
|---|---|---|---|
| One or less[1] | 292 | 63.1 | 63.1 |
| Two to five | 129 | 27.8 | 90.9 |
| Six to ten | 20 | 4.3 | 95.2 |
| Eleven or more | 22 | 4.8 | 100 |
| | 7 | Missing | |
| Total | 470 | 100 | |
| | | | |
| Mean | 2.888 | | |
| Median | 1 | | |
| Standard error | 0.429 | | |

Question # 6: Have you ever broken even?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 373 | 80.2 | 80.2 |
| No | 2 | 92 | 19.8 | 100 |
| | | 5 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

[1] Four franchisees had no outlets or their outlets were not currently opened.

Question # 7: In what year did you break even?

| Value label | Frequency | Percent | Cumulative % |
|---|---|---|---|
| 1 | 151 | 41.4 | 41.4 |
| 2 | 90 | 24.7 | 66 |
| 3 | 42 | 11.5 | 77.5 |
| 4 | 33 | 9 | 86.6 |
| 5 | 28 | 7.7 | 94.2 |
| Six to nineteen | 21 | 5.8 | 100 |
| | 105 | Missing | |
| Total | 470 | 100 | |
| | | | |
| Mean | 2.636 | | |
| Median | 2 | | |
| Standard error | 0.135 | | |

Question # 8: Have you ever profited from your franchise?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 370 | 79.4 | 79.4 |
| No | 2 | 96 | 20.6 | 100 |
| | | 4 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 1 | | |

Question # 9: If you broke even, did you earn what your expected you would based on the information your franchisor gave you?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 153 | 38.2 | 38.2 |
| No | 2 | 248 | 61.8 | 100 |
| | | 69 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 10: Has you franchisor encroached upon your business in any way?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 186 | 40.4 | 40.4 |
| No | 2 | 274 | 59.6 | 100 |
| | | 10 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 11a: If your franchisor has encroached upon your business, did your profits suffer?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 152 | 78.4 | 78.4 |
| No | 2 | 42 | 21.6 | 100 |
| | | 276 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 1 | | |

Question # 11b: By how much?

| Value label | Frequency | Percent | Cumulative % |
|---|---|---|---|
| 0 - 5% | 7 | 5 | 5 |
| 6 - 8% | 19 | 13.5 | 18.4 |
| 9 - 15% | 51 | 36.2 | 54.6 |
| 16 - 25% | 31 | 22 | 76.6 |
| 26 - 40% | 19 | 13.5 | 90.1 |
| Over 40% | 14 | 9.9 | 100 |
| | 328 | Missing | |
| Total | 470 | 100 | |
| | | | |
| Mean | 18.83 | | |
| Median | 9 - 15% | | |
| Standard error | 1.016 | | |

Question # 12: Did your franchisor compensate you for any of your losses?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 7 | 2.9 | 2.9 |
| No | 2 | 234 | 97.1 | 100 |
| | | 229 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 13: Has your franchisor ever coerced you into purchasing a new outlet nearby, by threatening to sell it to another franchisee if you didn't?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 46 | 10.3 | 10.3 |
| No | 2 | 402 | 89.7 | 100 |
| | | 22 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 14: Do you feel that you are getting the full value of the advertising fees you pay your franchisor?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 139 | 31.8 | 31.8 |
| No | 2 | 298 | 68.2 | 100 |
| | | 33 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 16: Have you ever tried to end your relationship with your franchisor only to find out that it was impossible to get out of the system?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 71 | 15.5 | 15.5 |
| No | 2 | 387 | 84.5 | 100 |
| | | 12 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 17: Have you ever been threatened by a representative of your franchisor?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 185 | 40.4 | 40.4 |
| No | 2 | 273 | 59.6 | 100 |
| | | 12 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 19: What would you guess is the failure rate of franchisees in your system over a three-year period?

| Value label | Frequency | Percent | Cumulative % |
|---|---|---|---|
| 2.50% or less | 40 | 12.4 | 12.4 |
| 2.51 - 5% | 44 | 13.7 | 26.1 |
| 5.01 - 10% | 71 | 22 | 48.1 |
| 10.01 - 20% | 59 | 18.4 | 66.5 |
| 20.01 - 30% | 60 | 18.6 | 85.1 |
| 30.01 - 50% | 31 | 9.6 | 94.7 |
| 50.01 - 100% | 17 | 5.3 | 100 |
| | 148 | Missing | |
| Total | 470 | 100 | |
| | | | |
| Mean | 19.261 | | |
| Median | 13.75 | | |
| Standard error | 0.983 | | |

Question # 20: Would you characterize the support services you receive from your franchisor as adequate?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 175 | 38.7 | 38.7 |
| No | 2 | 277 | 61.3 | 100 |
| | | 18 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 22a: Does your franchisor force you to discount your products or services?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 207 | 46.3 | 46.3 |
| No | 2 | 240 | 53.7 | 100 |
| | | 23 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 22b: If your franchisor forces you to discount your products and services, has this discounting/promotional activity increased over the last few years?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 168 | 78.9 | 78.9 |
| No | 2 | 45 | 21.1 | 100 |
| | | 257 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 1 | | |

Question # 23: [illegible]

| Value label | Frequency | Percent | Cumulative Percent |
|---|---|---|---|
| Increased 1-5% | [illegible] | 8.5 | 8.5 |
| Increased 6-8% | [illegible] | 4.3 | [illegible] |
| Increased 9-15% | [illegible] | 2.5 | [illegible] |
| Increased over 15% | [illegible] | 4.3 | [illegible] |
| Decreased 1-5% | [illegible] | [illegible] | 39.1 |
| Decreased 6-8% | [illegible] | [illegible] | 58.3 |
| Decreased 9-15% | [illegible] | 25 | 83.3 |
| Decreased over 15% | 46 | 16.7 | 100 |
| | 134 | Missing | |
| Total | 470 | 100 | |
| | | | |
| Mean | -6.398 | | |
| Median | decreased 6-8% | | |
| Standard error | 0.542 | | |

Question # 24: Do you purchase products or services from your franchisor that you feel are inflated in price?

| Value label | Value | Frequency | Percent | Cumulative Percent |
|---|---|---|---|---|
| Yes | 1 | 226 | 57.4 | 57.4 |
| No | 2 | 168 | 42.6 | 100 |
| | | 76 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 1 | | |

Question # 25: Must you purchase these things from your franchisor?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 135 | 31.6 | 31.6 |
| No | 2 | 292 | 68.4 | 100 |
| | | 43 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 26: Have you ever sued your franchisor?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 54 | 11.9 | 11.9 |
| No | 2 | 401 | 88.1 | 100 |
| | | 15 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 27: Have you and/or other franchisees in your system ever tried to form an independent franchisee association, but received pressure or threats from the franchisor causing you to give it up?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 104 | 24.4 | 24.4 |
| No | 2 | 322 | 75.6 | 100 |
| | | 44 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

Question # 28: Are you currently in a dispute of any kind with your franchisor?

| Value label | Value | Frequency | Percent | Cumulative % |
|---|---|---|---|---|
| Yes | 1 | 136 | 30.1 | 30.1 |
| No | 2 | 316 | 69.9 | 100 |
| | | 18 | Missing | |
| Total | | 470 | 100 | |
| | | | | |
| Median | | 2 | | |

## Appendix B

*Cross Tabulations for Selected Questions*

**Question # 10 by Question # 11a:**
Has your franchisor ever encroached upon your business in any way? by
*Did your profits suffer?*

| | | *Did your profits suffer?* | | |
|---|---|---|---|---|
| | | Yes | No | Total |
| Has your franchisor ever encroached upon your business in any way? | Yes | 152 (90.5%) | 16 (9.5%) | 168 (100.0%) |
| | No | | 22 | 22 |
| | Total | 152 | 38 | 190 |

**Question # 22a by Question # 23**
Does your franchisor force you to discount your products and services? by
*Have your profits increased or decreased over the long term as a result of such discounting/promotional activities?*

*Have your profits increased or decreased over the long term as a result of such discounting/ promotional activities?*

| | | Increased | | | | Decreased | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 1-5% | 6-8% | 9-15% | Over 15% | 1-5% | 6-8% | 9-15% | Over 15% | |
| Does your franchisor force you to discount your products and services? | Yes | 6 (3.3%) | 2 (1.1%) | 2 (1.1%) | 3 (1.7%) | 42 (23.3%) | 40 (22.2%) | 49 (27.2%) | 36 (20.0%) | 180 (100%) |
| | No | 12 (13.6%) | 9 (10.2) | 5 (5.7%) | 9 (10.2%) | 13 (14.8%) | 12 (13.6%) | 18 (20.5%) | 10 (11.4%) | 88 (100%) |
| | Total | 18 | 11 | 7 | 12 | 55 | 52 | 67 | 46 | 268 |

**Questions # 1 by Question # 3**

Overall, would you consider your franchise operation successful in terms of financial return? by

*Would you advise others to join your franchise system?*

| | | *Would you advise others to join your franchise system?* | | |
|---|---|---|---|---|
| | | Yes | No | Total |
| Overall, would you consider your franchise operation successful in terms of financial return? | Very successful | 59 (76.6%) | 18 (23.4%) | 77 (100%) |
| | Somewhat successful | 117 (51.7%) | 109 (48.3%) | 226 (100%) |
| | Somewhat unsuccessful | 16 (17.0%) | 78 (83.0%) | 94 (100%) |
| | Very unsuccessful | 6 (14.6%) | 35 (85.4%) | 41 (100%) |
| | **Total** | **198** | **240** | **438** |

**Question # 14 by Question # 15a, b, c**

Do you feel that you are getting the full value of the advertising fees you pay your franchisor? by

*If not, why not?*

| | | *If not, why not?* | | | |
|---|---|---|---|---|---|
| | | No say in where or how the money is spent. | The money all goes into a national advertising campaign that benefits the image of the chain, but not my particular store or local market. | Don't feel that all the money is spent on advertising. | Total |
| Do you feel that you are getting the full value of the advertising fees you pay your franchisor? | Yes | 2 | 4 | | 139 |
| | No | 122 | 152 | 114 | 298 |
| | Total | 124 | 156 | 114 | |

**Question # 17 by Question # 18a, b, c, d**

Have you ever been threatened by a representative of your franchisor? by
*If yes, in what way?*

| | | *If yes, in what way?* | | | | |
|---|---|---|---|---|---|---|
| | | Physically | Verbally | Financially | My franchisor threatened to terminate my franchise agreement, or not to renew it, or to keep me from expanding. | Total |
| Have you ever been threatened by a representative of your franchisor? | Yes | 4 | 108 | 83 | 106 | 185 |
| | No | | 1 | 1 | 3 | 273 |
| | Total | 4 | 109 | 84 | 109 | |

**Question # 20 by Question # 21a, b, c, d**

Would you characterize the support services you receive from your franchisor as adequate? by
*If no, why not?*

| | | *If no, why not?* | | | | |
|---|---|---|---|---|---|---|
| | | Franchisor does not provide the support services promised when I originally signed. | Franchisor used to provide a lot more support services, but over the years they have diminished. | The contract does not obligate the franchisor to provide much in the way of suppport services. | The number of support sevices has remained the same, but they are of lower quality. | Total |
| Would you characterize the support services you receive from your franchisor as adequate? | Yes | 3 | 1 | 3 | 2 | 175 |
| | No | 112 | 161 | 91 | 50 | 277 |
| | Total | 115 | 162 | 94 | 52 | |

**Question # 24 by Question # 25:**
Do you purchase products or services from your franchisor that you feel are inflated in price? by
*Must you purchase these things from your franchisor?*

| | | *Must you purchase these things from your franchisor?* | | |
|---|---|---|---|---|
| | | Yes | No | Total |
| Do you purchase products or services from your franchisor that you feel are inflated in price? | Yes | 113 (51.6%) | 106 (48.4%) | 219 (100.0%) |
| | No | 13 | 138 | 151 |
| | Total | 126 | 244 | 370 |

**Question # 26 by Question # 28:**
Have you ever sued your franchisor? by
*Are you currently in a dispute with your franchisor?*

| | | *Are you currently in a dispute with your franchisor?* | | |
|---|---|---|---|---|
| | | Yes | No | Total |
| Have you ever sued your franchisor? | Yes | 34 (63.0%) | 20 (37.0%) | 54 (100.0%) |
| | No | 99 (25.3%) | 292 (74.7%) | 391 (100%) |
| | Total | 133 | 312 | 445 |

# Appendix C

## Franchisee Representation, by Industry and Chain

**Summary**

The AFA Franchisee Satisfaction Survey asked the franchisee respondents to indicate their industry area, with the option of including their specific chain name. Some 175 respondents, or 37.2% of the total, did not indicate either industry category or chain name.

- Of the categories where responses were indicated, 40.2% are known to be from three industries: convenience stores, fast food and shipping/mailing services.
- Another 12.2% are known to be from quick oil change and lodging.
- The remaining 10.8% are divided among 13 additional industry areas.

| | |
|---|---|
| Industry not indicated: | 37.2% |
| Convenience store: | 16.1% |
| Fast food: | 14.8% |
| Mailing service: | 8.9% |
| Quick oil change: | 7.2% |
| Lodging: | 5.0% |
| Other: | 10.8% |

| Franchisee Organization | Frequency | Percent | Cumulative Percent |
|---|---|---|---|
| Not Indicated | 175 | 37.2 | 37.2 |
| 7-Eleven | 73 | 15.5 | 52.7 |
| Mail Boxes Etc. | 41 | 8.7 | 61.4 |
| KFC | 40 | 8.5 | 69.9 |
| Jiffy Lube | 32 | 6.8 | 76.7 |
| ServPro Industries | 11 | 2.3 | 79.0 |
| Pearle Vision | 11 | 2.3 | 81.3 |
| Dunkin Donuts | 9 | 1.9 | 83.2 |
| Schlotzsky's | 6 | 1.3 | 84.5 |
| Days Inn | 6 | 1.3 | 85.8 |
| ADIA Personnel | 5 | 1.1 | 86.9 |
| Little Caesar's | 4 | .9 | 87.8 |
| Barbizon Schools | 4 | .9 | 88.7 |
| Asian American Hoteliers | 4 | .9 | 89.6 |
| EconoLodge | 3 | .6 | 90.2 |
| Super 8 | 3 | .6 | 90.8 |
| Burger King | 2 | .4 | 91.2 |
| Taco Bell | 2 | .4 | 91.6 |
| Scandia Down Shops | 2 | .4 | 92.0 |
| Convenient Food Mart | 2 | .4 | 92.4 |
| Happy Joe's Pizza | 2 | .4 | 92.8 |
| Dima Resorts | 2 | .4 | 93.2 |
| Radio Shack | 2 | .4 | 93.6 |
| Pasquale Food Systems | 1 | .2 | 93.8 |
| Decorating Den | 1 | .2 | 94.0 |
| Fantastic Sam's | 1 | .2 | 94.2 |
| The Book Place | 1 | .2 | 94.4 |
| H&R Block | 1 | .2 | 94.6 |
| A&W Restaurants | 1 | .2 | 94.8 |
| SpeeDee Oil Change | 1 | .2 | 95.0 |
| Oil Express | 1 | .2 | 95.2 |
| Hardee's | 1 | .2 | 95.4 |
| Godfather's Pizza | 1 | .2 | 95.6 |
| PIP Printing | 1 | .2 | 95.8 |
| Midas Muffler & Brake | 1 | .2 | 96.0 |
| Carvel | 1 | .2 | 96.2 |
| Snelling Personnel | 1 | .2 | 96.4 |
| White Hen Pantry | 1 | .2 | 96.6 |
| Packaging Store | 1 | .2 | 96.8 |
| Kitchen Tune-Up | 1 | .2 | 97.0 |
| Supercuts | 1 | .2 | 97.2 |
| Jani-King | 1 | .2 | 97.4 |
| Domino's | 1 | .2 | 97.6 |
| Subway Sandwiches | 1 | .2 | 97.8 |
| Roto-Rooter | 1 | .2 | 98.0 |
| Comfort Suites | 1 | .2 | 98.2 |
| Scottish Inns | 1 | .2 | 98.4 |
| Ho Jo Inn | 1 | .2 | 98.6 |
| Day Stop | 1 | .2 | 98.8 |
| Quality Inn | 1 | .2 | 99.0 |
| Gene's Electronics | 1 | .2 | 99.2 |
| Comfort Inn | 1 | .2 | 99.4 |
| TOTAL | 470 | | 100 |

Mr. GEKAS. We thank the lady, and we turn to the next witness, Mr. Adler.

But before we do, let the record indicate that the gentleman from Ohio, Mr. Chabot, is present, and that the gentleman from Florida, Mr. Scarborough, is also present for these proceedings.

Mr. Adler, recognized for 5 minutes.

## STATEMENT OF MICHAEL F. ADLER, CHAIRMAN, PRESIDENT, AND CEO, MOTO-PHOTO, INC., FRANCHISOR, DAYTON, OH, ON BEHALF OF INTERNATIONAL FRANCHISE ASSOCIATION

Mr. ADLER. Thank you, Mr. Chairman; thank you, committee members.

First of all, I just want to add that I am a representative of the IFA. The IFA probably foolishly chose to have me speak instead of a paid staff member, because I do live in the world of franchising, and with my franchisees and franchisors of many companies, and actively involved in the IFA.

A little background—our family has been in the photographic industry for over 50 years, starting with a small camera store in Springfield, Ohio. My dad drew the business, and we became the 10th largest wholesale photo finisher in the United States. A tough business, commodity business, and we wanted to be dealing more directly, in a more intimate way in the photographic world with our customers. And we elected to go into franchising. In 1982, we opened five test stores, and we were delighted they were successful.

We were determined to build a national chain. To do that, we needed talent, and we needed lots of money. I am sad to say, we looked in the mirror—not a lot of talent, and we didn't have a lot of money. So we decided, how can we put this together? So, we chose franchising for several reasons.

Why franchising? But first of all, you can attract passionate, dedicated people who are really in pursuit of their own dream, in a way that you couldn't hire these same people. The second thing is, we could build a national company doing strategic planning, developing programs that an individual owner just can't have, and we really could build a national chain.

We had another plus, too, consistent with our values, which I thought were somewhat unique to Moto-Photo, but that value is—and it is not unique to Moto-Photo; I find it just almost universal in the world of franchising because it is the only way that works—a win/win relationship. When it is a win and a loser, everybody loses. And so we decided to pursue franchising.

In 1983, we acquired a fledgling franchise company with the unlikely name, Moto-Photo, and moved it to Dayton, Ohio—1 assistant and 1 file cabinet and 11 stores.

Today, Moto-Photo is a publicly-held company. We have 419 state-of-the-art, on-site processing stores, portrait studios, operating in 29 States in the U.S. and in Canada and Norway.

It has not always been an easy experience; it has been very challenging. I cite that; it may come as a surprise to you. I am 25 years old and look what it has done to me. [Laughter.]

Nevertheless, Moto has emerged as the leading franchise system in the U.S. Success Magazine selected us in their top 100, and we were 15—the good news. The bad news—there were 14 ahead of us, but we are proud of that. Entrepreneur selected us as top of the category. We do on balance—on balance—have great relations with our franchisees. Why is that?

We try to operate as a team. We have Franchise Advisory Councils. We have a Chairman's Advisory Council. One of our prominent franchisees who is a large shareholder in Moto-Photo sits on our board of directors—is also, in 2 years, will be a head of the IFA's Franchisee Advisory Committee. We strive—not always successfully—but we always strive to have a win/win situation. We go to extraordinary lengths, on an individual basis, to help our franchisees. From a financial perspective, we have carried many of our franchisees longer than their mother carried them.

I would like to address what I view as the heart of these hearings. When I hear people talk about it, I hardly recognize the world of franchising that I and my other franchising colleagues live in.

Do we need more Federal regulations to govern the relationship between the franchisor and the franchisee? I think unqualifiedly "no." Now I bring unique perspective to this, and you need to know that. I know you will share my little secret here. I am an undiagnosed schizophrenic. On one hand, I am a liberal Democrat; I mean my name was probably Nadler before our family shortened it. [Laughter.]

Not true, but I will—[Laughter.]

Mr. NADLER. So far, you are correct. [Laughter.]

Mr. ADLER. Yes, I did. [Laughter.]

I happen to believe that legislation—there is a need for legislation to protect people, but it has to be a pretty serious need.

But on the other hand—my schizophrenia-side—I am a business person, and we are not a big business. A big mistake about franchisors being big business, is as one of the representatives said, most are small businesses. It is so burdensome, you cannot imagine the legal constraints we have—not about franchising, just all of the legal constraints. Just franchising is just one more.

On one hand, I am a franchisor, and I really am passionate about our position, our beliefs, because it works. On the other hand, you need to know, I am a successful franchisee in our own system. I make a lot of money from the best investment I have, better than my franchisor-side of the house. I understand the problems, and I sometimes bristle when our own company, which I am a part of, comes up with system guidelines that we try to persuade our franchisees to participate in.

I think there are three huge reasons not to impose any more burdens on the franchisor and franchisee relationship.

One is the legal costs. Moto is a company with $40 million in sales. We are not even a micro-cap company in today's world. We are a company with no serious legal problems. And yet good news for the lawyers on this panel. In any given time, we can employ up to 10 legal firms, law firms, to represent our different interests—unbelievable. We are not in any litigation—10 firms. How many—God knows how many lawyers—costing us hundreds of thousands of dollars. that is money that is not devoted to marketing, not going in the franchisees pockets, not going into our corporate associate's pocket, and not going in our shareholder's pocket.

The second is—and I do bristle when I hear lawyers who, their first instinct—remember my logic—don't mention that either. The first thing they talk about is adversarial relationships. Franchisees works because it is a partnership. It is a partnership, and when that becomes destroyed, the whole underpinning of this system will go down the tubes.

The third is—let me dwell on that for 1 minute. The proposed legislation that was before you a year ago just encourages litigation. It weakens the contract that people willingly or knowingly enter into, and it moves most of all from a strategic, not from a legal point of view. It moves the focus of the relationship from disputes with each other to focusing on the customer who pays all of our bills.

And, finally, it weakens the brand. If we cannot enforce standards, our brand will go down the tubes. Most of the legal action we have initiated—which is not very much—is at the insistence of other franchisees who say to us, "You promised you would keep a great brand. You promised that all the stores would give excellent service and quality. Moto, you are absolutely not protecting our brand. You need to do it." In some cases, that franchisee is paying our bills. I need a legal cost like a hole in the head, and yet I know I have to protect the brand. If I don't have a strong contract, everybody is harmed.

Mr. GEKAS.You will have to— —

Mr. ADLER. Can I have another minute, if I may?

Mr. GEKAS. [continuing]. Draw your conclusions here.

Mr. ADLER. Do franchisors and franchisees abuse each other? Yes, there are isolated cases of it.

How do we protect the franchisees? Well, first of all—and I won't go into it—but the predisclosure documents are outstanding. I don't agree with my good friend, Susan. And one thing in it is so simple. You, as a prospect, have but to pick up the phone and call every person who is a franchisee of a system. You can find out who are the good guys or the bad guys.

You enter into a contract, and there is a huge misunderstanding about the contract. A lot of this discussion is based on a fallacious assumption that the contract is to protect the franchisor. Wrong—the contract is to protect the system. Every time a franchisor is drawn into litigation, every time a franchisee does not want to upgrade their store, every time the franchisee does not want to enforce good quality and service, every other franchisee's investment is a peril.

Finally, what should the government do to impact their contractual relationship? I go back to James Carville's advice, some modification to President Clinton, when he said to them about being focused, he said, "It is the economy, Stupid." In this case, I would like to add, it is the contract and it is the marketplace, committee members. Essentially, franchisees—I am not stupid—essentially, franchisees systems works 99 percent of the time. If you start getting in, and we put a lot of legislation in, we will tear it asunder.

Mr. GEKAS.The time— —

Mr. ADLER. Thank you.

Mr. GEKAS. [continuing]. Of the gentleman has expired.

[The prepared statement of Mr. Adler follows:]

PREPARED STATEMENT OF MICHAEL F. ADLER, CHAIRMAN, PRESIDENT, AND CEO, MOTO-PHOTO, INC., FRANCHISOR, DAYTON, OH, ON BEHALF OF INTERNATIONAL FRANCHISE ASSOCIATION

Chairman Gekas and Committee Members:

Thank you for the opportunity to tell the Moto Photo story and the role that franchising has played in our success.

Moto Photo is a young company. In 1982 our management opened five stores to test a new one-hour film-processing concept. The results were impressive. We concluded that our business was like the Peter Sellers' movie: There was a war and we were not involved. Well, in our case, there was a marketing revolution about to take place, and we had not been invited. We decided that we wanted to be a part of the revolution and as a franchise company.

Today, Moto Photo is a publicly held company with 419 stores operating in the United States, Canada and Norway. We have 387 stores that are franchised and 32 company owned. In FY 1999, corporate revenues will be approximately $40,000,000 and system wide revenues $140,000,000.

Moto Photo has developed into a full imaging service concept offering one-hour processing, enlargements, portrait studios and photo related merchandise located in strip centers and major malls.

Why did Moto Photo choose to adopt franchising as a cornerstone of its business strategy? The answer lies in our own past business experience. The core of our management team comes from the wholesale photofinishing business in which our company, Progressive Industries Corporation, operated major wholesale photofinishing plants. We grew this business to become the 10th largest wholesale photofinisher in the United States.

There were several painful lessons learned in this endeavor. First, occupying 10th place in any activity is not an admirable position whether it is a business, a horse race or a pennant drive. Business was tough. Small businesses rarely have the resources to obtain purchasing power, marketing clout or systems support even though they do have the advantage of flexibility, fast reaction time and entrepreneurial drive. Ours was no exception. We decided we would enter this new market with a stronger business strategy.

## WHY FRANCHISING?

Based on our past experience, we decided to enter this new business with two goals. First, we intended to be a leader. Second, we wanted a culture committed to participative management, group decision making and win/win relationships. To achieve these goals, we needed a business strategy that would generate a substantial amount of capital and unlimited access to high-powered managerial talent.

We chose to become a franchising company as one of our major business strategies. Why? Franchising is one of the few strategies that enable the small businessperson to compete against large competitors on a level playing field. It enables the franchisor to achieve rapid growth and a level of personal commitment rarely found in other businesses. While the franchisor has to provide the capital to create and sustain the infrastructure, it is the franchisees that invest capital for each store location. Franchisees also contribute talent that is often not available at any cost. They are generally mature, experienced business people who want to be in a business for themselves but not by themselves.

## FRANCHISING IS NOT AN INDUSTRY

People treat franchise companies as a homogeneous industry. Nothing could be further from the truth. For example, Moto Photo is not McDonald's, nor would ever become McDonald's. Our customer profile is different as is our product, franchisee profile, investment, marketing strategy, location strategy, information systems, etc. The only similarity is that we both have chosen to build our businesses through the franchising business strategy.

## KEYS TO SUCCESSFUL FRANCHISOR-FRANCHISEE RELATIONSHIPS

Over the past eleven years, we have learned that franchising is a fragile relationship bonded together by a common vision and common values. While our mission statement speaks both to vision and value, I would like to discuss values that are commonly found in successful franchise systems.

1. *Trust.* The franchise relationship may last twenty to thirty years. Like a successful marriage, this relationship needs to be built on a solid bedrock of trust. Actions by any party that alters the truth, promotes greed or fosters divisive behaviors undermines trust.

2. *Win/Win.* The partners need to believe that everyone should be a winner in the relationship including customers, associates, franchisees, shareholders and suppliers. In the short term, profits can be maximized with win/lose situations, but not in the long term. When every stakeholder wins in the relationship, the relationships are strengthened and the institution prospers. If one stakeholder loses, ultimately the institution will unravel.

3. *Dispute resolution through problem solving rather than adversarial proceedings.* Adversarial proceedings create a loser and maybe a winner. Creative problem solving creates winners. Problem solving presupposes that the partners are looking for both parties to triumph. Moto Photo approaches differences with this philosophy and in most cases, disputes are resolved in a friendly, constructive environment.

4. *Adult/Adult relationships.* Franchisors are not the parents and franchisees the children, but both parties are mature adults who come into the relationship with a commonality of interest. At Moto Photo, we believe that we should all treat each other as adults, and that when treated as competent adults we will respond as competent adults.

5. *Group decision-making.* Companies employing the franchising strategy have been the leaders in employing participative management and group decision making. Franchisees bring an important perspective to decision making that is not available at the franchisor's corporate office. Franchisees deal with customers face to face; they battle competitors on a daily basis and employ the system's programs. By thoroughly involving the franchisees in the decision making process, the quality of the decision making and the level of commitment to the ultimate decisions is extraordinary. This is why most franchise systems use franchisee advisory councils and boards. When it comes to "empowerment strategies," franchisors are on the cutting edge.

6. *Protect the integrity of the system.* Both partners in the franchise system, the franchisor and the franchisee, are dependent upon the customer's perception of its brand. Surprisingly, in the few instances that Moto Photo has reverted to an adversarial arbitration process to enforce contracts, it has taken the action on the initiative and insistence of other franchisees. For example, if a franchisee persists in running a dirty store, abusing customers, selling shoddy quality, reneging on contributions to an advertising co-op, the fellow franchisees in that community are harmed more quickly than the franchisor. Strong franchise agreements are generally required not just to protect the franchisor, but to protect all parties who have chosen to invest their capital and lives into the strength of the entire system. If franchise agreements are weakened unwisely through legislation, ultimately the value of every franchise is diminished.

At Moto Photo, we have tried diligently to practice and protect these values. It has paid off. Our system has been recognized as one of the top 100 franchises in the United States (31st position) in Success magazine and Ernst & Young's ranking, placing Moto in the top one percent of all franchises in North America. Our Canadian affiliate was recognized as the number one Canadian franchise for its relations with our franchisees by a ranking sponsored by the Canadian Franchise Association and the Royal Bank of Canada. For the past four years, Moto Photo has been essentially free of litigation with its franchisees and our system has grown and prospered.

I have been delighted and surprised with the values of other companies employing the franchising strategy. I thought the values I've discussed were essentially unique to Moto Photo and a select group of companies throughout the country. Not so. These values are widely adhered to in the franchising community because it is the relationship with our franchisee partners that make franchising successful.

As this subcommittee becomes more familiar with the workings of franchising, I believe you will become as excited as I have about its past accomplishments and its enormous future potential for assisting small businessowners to achieve their dreams. I believe we represent the very best values in American life, creating economic wealth and raising the standards of living for our population.

I strongly urge Congress to avoid legislation that encourages costly, divisive and unproductive adversarial action by either the franchisee or franchisor. Our society has greatly suffered with its preoccupation to resolve its disputes via litigation.

We need your Congressional assistance and your wisdom to protect us against smothering legislation that will extinguish the bright hopes that franchising brings to hundreds of thousands of franchisees and hundreds of millions of its customers.

Thank you for the opportunity to appear before this subcommittee. Please do not hesitate to call on our company if we can be of further assistance.

Mr. GEKAS. Mr. Leddy is now recognized for 5 minutes.

## STATEMENT OF PATRICK JAMES LEDDY, JR., BASKIN-ROBBINS FRANCHISEE, VALENCIA, CA

Mr. LEDDY. Thank you, Mr. Chairman, committee.

My name is Patrick James Leddy, Jr. I have owned and operated a Baskin-Robbins 31 Flavors for 13 years. I am also a 26-year veteran firefighter of the Los Angeles City Fire Department. I purchased my franchised business to supplement my income and to prepare my wife and I for our retirement.

In 1996, my wife and I became very discouraged with the manner in which our franchisor, which is a wholly-owned subsidiary of a foreign corporation, was treating its franchisees. After careful consideration and after seeing sales at our fellow franchisee's stores plummet as a result of the placement of new stores and drastic changes in the system which we had originally purchased, we decided to sell our store.

In February 1997, 3 months after notifying Baskin-Robbins that we were interested in selling our store, we received notification that Baskin-Robbins was considering a location for a new store located in a shopping mall a mere two miles from our store.

My wife and I met with our district manager to discuss the ability to sell our store and the tremendous impact the new store would have on our existing store. To our surprise, the representative from Baskin-Robbins agreed with us and suggested that if Baskin-Robbins were to go forward with this plan, how would we feel if they were to purchase our store and then sell both our store and the new store as a package to a new buyer?

We agreed that this would be acceptable to us. Whereafter, the Baskin-Robbins representative offered us $40,000 less than what I had paid for the store 7 years earlier, and after an additional $70,000 that I had paid for improvements which were required by Baskin-Robbins.

We were appalled after this offer, but were advised by the Baskin-Robbins representative that we really should consider his offer because if Baskin-Robbins does elect to place this new store at the proposed location, our store wouldn't even be worth that amount.

In April 1997, and pursuant to an internal policy of Baskin-Robbins, which is not binding on Baskin-Robbins, and which is rarely followed by the company, I submitted to my district manager my response to this Baskin-Robbins proposed new location. He assured me that he would notify me of any developments as they occur, and that we would be promptly notified once a determination had been made.

After several unsuccessful attempts to learn whether Baskin-Robbins would proceed with the new store, my wife called our district manger and explained to him that we needed immediate information on what the company intends to do about this new site, because we have had several prospective buyers for our stores that were disinterested once we disclosed to them Baskin-Robbins' plan. The Baskin-Robbins representative advised us not to disclose the information about the new store to the prospective buyers.

In July 1997, our local neighborhood magazine publication reported that a new Baskin-Robbins would be open two miles for our store. We were shocked. Two days after this news story appeared, and after numerous telephone calls to Baskin-Robbins on our part, we finally received official notification from Baskin-Robbins about the new store.

On August 5, 1997, my wife and I decided in our best interest, we should retain legal representation regarding the encroachment issue and the subsequent issue of our inability to sell our store.

In June 1998, the new store opened, and with their grand opening celebration following in August. As a result, sales at our store have drastically declined and have effectively terminated our ability to sell the store at a reasonable price.

While attempting to resolve matters through our attorney, Baskin-Robbins has become increasingly hostile toward us. They have begun arbitrarily rating us as "C" franchisees, when in the past, we had always maintained an "A" or "B" rating. In addition, they have brought against us a lawsuit contending that we are poor operators.

One week before the inspection that is the basis for their lawsuit however, a mystery shopper trained and employed by Baskin-Robbins rated our operation "superior," as did the Los Angeles County Health Inspector.

In closing, I would ask your full support in addressing the obvious imbalance in the relationship between franchisor and franchisee through legislation. I am one franchisee of many that are so frustrated in the way that we are literally forced to do business.

Many franchisees that I know of have lost their business, are going to lose their business, or are just plain hanging in there because there is nothing else they can do. I am extremely fortunate that I have another profession to fall back onto, while others suffer from intimidation, or being afraid to stand up and say anything for fear that they will be strong-armed into submission, as Baskin-Robbins has attempted to do to me.

Please, give us the tools that we need to survive in this giant corporate world, so that us little guys can continue making those big guys who they are.

Thank you.

[The prepared statement of Mr. Leddy follows:]

PREPARED STATEMENT OF PATRICK JAMES LEDDY, JR., BASKIN-ROBBINS FRANCHISEE, VALENCIA, CA

My name is Patrick James Leddy Jr. I have owned and operated a Baskin-Robbins 31 Flavors franchise in Newhall, California since August 1, 1986, a total of 13 years. I am also a 26 year veteran firefighter with the Los Angeles City Fire Department. I purchased my franchised business to supplement my income, and to prepare my wife and I for our retirement. In 1996 my wife and I became very discouraged with the manner in which our Franchisor, which is a wholely owned subsidiary of a foreign corporation, was treating its franchisees. After careful consideration and after seeing sales at our fellow franchisee's stores plummet as a result of the placement of new stores and drastic changes to the system which we had originally purchased, we decided to sell our store.

In February of 1997, three months after notifying Baskin-Robbins that we were interested in selling our store, we received a notification that Baskin-Robbins was considering a location for a new store located in a shopping mall, a mere two miles from my store and well within the market from which we draw a large number of our customers.

Later that month my wife and I met with our district manager to discuss our ability to sell our store and the tremendous impact the new store would have on our existing store. To our surprise the representative from Baskin-Robbins agreed with us, and suggested that if Baskin-Robbins were to go forward with this plan, how would we feel if they were to purchase our store, and then sell both our store and the new store as a package to a new buyer? We agreed that this would be acceptable to us. Whereafter, the Baskin Robins representative offered us $40,000 dollars less than what I had paid for this store seven years earlier, and after an additional $70,000 dollars I paid for improvements which were required by Baskin-Robbins. We were appalled at this offer, but were advised by the Baskin-Robbins representative that we really should considert his offer, because if Baskin-Robbins does elect to place this new store at the proposed location, our store wouldn't even be worth that amount.

Thereafter in April of 1997, and pursuant to an internal policy of Baskin-Robbins, which is not binding on Baskin-Robbins, and which is rarely followed by the company, I submitted to my district manager my response to this Baskin-Robbins proposed new location. He assured me that he would notify me of any developments as they occur, and that we would be notified promptly, once a determination had been made.

In June of 1997, after several unsuccesfull attempts to learn whether Baskin-Robbins would proceed with the new store my wife called our district manager and explained to him that we needed immediate information on what the company intends to do about this new site, because we have had several prospective buyers for our store that were disinterested once we disclosed to them Baskin-Robbins' plan. The Baskin-Robbins representative advised us not to disclose the information about the new store to our prospective buyers.

In July of 1997, our local neighborhood magazine publications reported that a new Baskin-Robbins would be open two miles from our store. We were shocked. Two days after this news story appeared, and after numerous telephone calls to Baskin-Robbins on our part, we finally received official notification from Baskin-Robbins about the new store.

We later learned that Baskin-Robbins signed the lease for this new store on May 13, 1997.

On August 5,1997, after the underhandedness that we had felt from Baskin-Robbins, my wife and I decided that in our best interest we should retain legal representation to help us resolve the matter with Baskin-Robbins regarding the encroachment issue and the subsequent issue of our inability to sell our store.

In June of 1998 the new store opened, with their grand opening celebration following in August. As you can see on the enclosed charts, sales at our store have drastically declined as a result, and have effectively terminated our ability to sell the store at a reasonable price.

While attempting to resolve matters through our attorney, Baskin-Robbins has become increasingly hostile towards us. They have begun arbitrarily rating us as "C" franchisees, when in the past , we had always maintained an "A" or "B" rating. In Addition, they have brought against us a lawsuit, contending that we were poor operators. One week before the inspection that is the basis for their lawsuit however, a mystery shopper trained and employed by Baskin-Robbins rated our operation superior, as did the LA county Health Inspector.

In closing, I would ask your full support in addressing the obvious imbalance in the relationship between franchisor and franchisee through legislation. I am one Franchisee of many that are so frustrated in the way that we are literally forced to do business. Many franchisees I know that have lost their businesses, are going to lose there businesses, or are just plain hanging in there because there's nothing else they can do. I am extremely fortunate that I have another profession to fall back onto, while others suffer from intimidation, or being afraid to stand up and say anything, for fear that they will be strong-armed into submission, as Baskin-Robbins has attempted to do to me. Please, give us the tools that we need to survive in this giant corporate world, so that us little guys can continue making those big guys who they are.

Thank you

*April 14, 1997.*

Keith A. Bakker, *Business Consultant,*
*Allied Domecq Retailing USA,*
*District #6.*

DEAR MR. BAKKER, I would like to thank you for both the opportunity to respond to this new BR proposed location at McBean and the I-5 freeway, and allowing me some extra time to do so. As you know, I hold down two full time occupations, and time is my worst enemy. I definitely haven't had enough time to put this package together as I would like, but I will touch on what I think are the important areas.

I've been a Baskin-Robbins franchisee for eleven years. My wife and I operate our store with the highest standards. We often receive compliments from our customers, and people throughout the community. They appreciate our courteous, professional staff and the cleanliness of our store. In fact we were given an "A" rating in the latest BR franchisee performance evaluation.

Almost seven years ago we purchased our present store. We bought this business for two reasons, one of them to supplement our income and the second as an investment for our retirement. We have worked very diligently to increase our customer market, our gross sales, and the equity in the store. In November 1996 we decided it was time for us to sell our store, so we submitted the "Store Resale Notice" forms to Baskin-Robbins, and according to Terrence Lewis our store was placed on the Baskin-Robbins resale list. On February 10 we received your letter informing us of your proposed new BR store site. You have essentially taken our store off the market with this notification. We can't sell it. The prospective buyers that have contacted us were disinterested once we disclosed to them your new proposed site.

Included in this package is a map of the Santa Clarita Valley, provided by the Automobile Club of Southern California. I have outlined the area zip codes and have marked the locations of all three existing Baskin-Robbins stores in the valley depicted by the yellow markers. In addition, I marked the location of your proposed site depicted by the red marker. As you can see, the company did a very good job in its location selections of the three existing stores. They are situated basically in their own respective communities, have a minimum of three and a half miles between them, and have areas for future growth. On the other hand, your new proposed site is one of very poor judgement. As you can see, it is located in the same community as our store, with only one and three quarter miles between the two. This proposed site as any educated person can see will cause both stores to draw from the same market area. Notice that there is no development to the North, West, or South of your proposed location except for the small community of Stevenson Ranch which those residents currently patronize our store. As you can see your new store would have no other market area to draw from other than the same market area in which our store depends on for its survival. By placing a new store in this location you will not only eliminate any future growth for our store, but would be constituting a gross case of encroachment.

Following are some statistics that I have logged since being notified of this site proposal. This information is from our established market which includes the three zip codes in order of population size; 91355, 91321, 91381.

1. Birthday club members:

I contacted Terry in the birthday club department and she gave me the closest estimates possible, also in the last month we have signed up additional members.

| | 91355 | 91321 | 91381 |
|---|---|---|---|
| current | 575 | 475 | 81 |
| new | 57 | 52 | 21 |
| | 632(50%) | 527(42%) | 102(8%) |

2. Birthday club redemptions:

I've recorded the redemptions over approximately the last month.

| 91355 | 91321 | 91381 |
|---|---|---|
| 27(52%) | 15(29%) | 10(19%) |

3. Construx Sweepstakes contest:

I've recorded the contest entry forms.

| 91355 | 91321 | 91381 |
|---|---|---|
| 38(38%) | 52(51%) | 11 (11%) |

Keep in mind that these numbers represent only a very small portion of our customer base. It does indicate that each of these zip codes, in respect to their size, are an established market of our store and would surely be jeopardized with your proposed site. You will notice that our largest customer base just in these three areas are from the 91355 zip code area, and over the years of behind the counter experience and running this business I find this to be fact. Also, the small community of Stevenson Ranch holds its own in our market. This will all end with this proposed site. According to your own BR "Traffic Volume" map and marketing information for this proposed site, it shows that the greatest concentration for a market base comes from this very same area.

In summation I am not a marketing expert. I am a fireman and I own and operate a Baskin-Robbins store, and I do them both very well as I wish you would do with your new site selection process. This means the abandonment of your idea of putting a new store at McBean and the I–5 freeway. You have essentially taken our store off of the resale market and are threatening us with the cannibalization of our store.

Two years ago at our 1995 Las Vegas convention your slogan was $400,000.00 by the year 2000, implying that we could look forward to our stores grossing this figure. Ourselves and many other franchisees knew it would not happen. Not only did we not go in that direction but our gross figures declined. This year at our 1997 convention the echo was for more success. You asked us to just trust the company, follow the programs and we will all prosper. During this whole charade I am thinking what I am faced with back home with this new site proposal. Why should I trust a company that would come up with an idea of sinking one of their own ships. With two stores in this area it would increase the overall gallonage for the company but would destroy us as individual franchisees. It would only be a matter of time before one of the two stores would be eliminated.

Remember the "Win Win" situation with Dennys, and "We'll do the right thing". You wanted us to trust the company in going in this direction of allowing Dennys' to sell BR ice cream. We franchisees were very concerned at that time about cannibalization of our stores, but the simple truth is that they were Dennys' and we are Baskin-Robbins, not a lot to worry about, and we didn't. You see, competing with different brands is not real difficult in our market, because we offer a lot that they don't. On the other hand, you want to put another Baskin-Robbins store, our own company right in our established marketplace. This is gross encroachment! Any franchisor that would place another of their own stores in such close proximity of an existing one, if nothing else would be breaching the basic principals of good faith and fair dealing.

I suggest that you abandon this, and any other future ideas in this area. We have enough BR stores in this area for its size and population, and frankly we would like to have some growing room so it would be possible to prosper.

PATRICK J.LEDDY JR., *Owner, Store #3075.*

ALLIED DOMECQ RETAILING USA,
*Glendale, CA, July 2, 1997.*

MR. PATRICK J. LEDDY, JR.
*Baskin-Robbins Store #3075,*
*Newhall, CA.*

Re: Approved new Baskin-Robbins—Valencia Marketplace Valencia, California

DEAR MR. LEDDY: Thank you for the documentation submitted to Mr. Keith Bakker regarding the proposed new store to be located in the Valencia Marketplace, Valencia. California. I understand your concerns regarding proximity issues. Believe me as Director of Retail Development I deal with proximity issues almost on a daily basis. As such, I take evaluation of proximity between Baskin-Robbins stores very seriously.

When evaluating the opportunity of developing new Baskin-Robbins stores we evaluate several key issues, first is the distance between each existing store and the proposed location, second we evaluate the type of retail/commercial development that surrounds each existing store, (particularly the same retail uses), third we look at drive patterns to visit these retail/commercial centers; fourth we evaluate density of population that surrounds the existing units as well as for the proposed site, and fifth we look at the overall markets as to new development both residential and retail/commercial.

In regards to our decision to approve the proposed new site at Valencia Marketplace, several key findings were identified. First the proposed site was determined to be 2.2 mile from your existing store in what we determined a separate market area due to the barrier created by Interstate 5. To support this, we noted that Von's is locating their flag ship concept Von Pavillion at the subject Valencia Marketplace while also maintaining a Von's market on Lyons Avenue approximately 1.3 miles from the new Von Pavillion. Also, Hughes market has also recently entered the market west of Interstate 5 which adds credibility to the growth of this market and the creation of a separate market. Where as in the past, residents on the west side of Interstate 5 and those to the east with close proximity to Interstate 5 had to shop the Lyons Avenue retail corridor. With the tremendous retail development west of Interstate 5, residents do not need to travel as far for their daily needs and services, thus eliminating many visits to the Lyons Avenue area. In essence, there is the same type of retail uses surrounding the proposed new site as that which surrounds your location on Lyons Avenue.

Next, we evaluated the density of population that surrounds the new site and the Lyons Avenue site. The new site has an 1995 estimated population of 9,795 within 1 mile radius and 31,719 within a 2 mile radius. The existing BR 43075 has an 1995 estimated population of 18,571 within 1 mile and 48,759 within a 2 mile radius. When compared to our new site criteria of 10,000 population 1 mile and 25,000 people within 2 miles, it supported our option that more than adequate population exists to support the new and existing Baskin-Robbins locations. It was also noted that significant residential growth is occurring and planned for the market west of Interstate 5.

Finally, it was brought to our attention that should we not enter this new growth market, a competitive ice cream use would be targeted as the developer wants an ice cream use in the center.

After evaluating the aforementioned facts and population data, it was determined that new site should be approved for development.

Considering our decision to move forward with this new location, we propose the following options for your consideration should you still feel the new location will have impact on your existing location. First, you always have the opportunity to file a grievance after the new unit is open and you can present documentation showing, sales transfer. Secondly, if you are still considering selling your store, we can work together to determine a fair market value and assist you in selling your store singularly or as part of multi-unit package with the new location. Possibly there are other options and we remain open to future discussion to address your issues and concerns.

Please feel free to call me or Keith Bakker to discuss the contents of this letter and any other questions you may have.

Sincerely,

E. MIKE AUSTIN, *Director Retail Development, Western Region.*

# Baskin - Robbins Store 3075

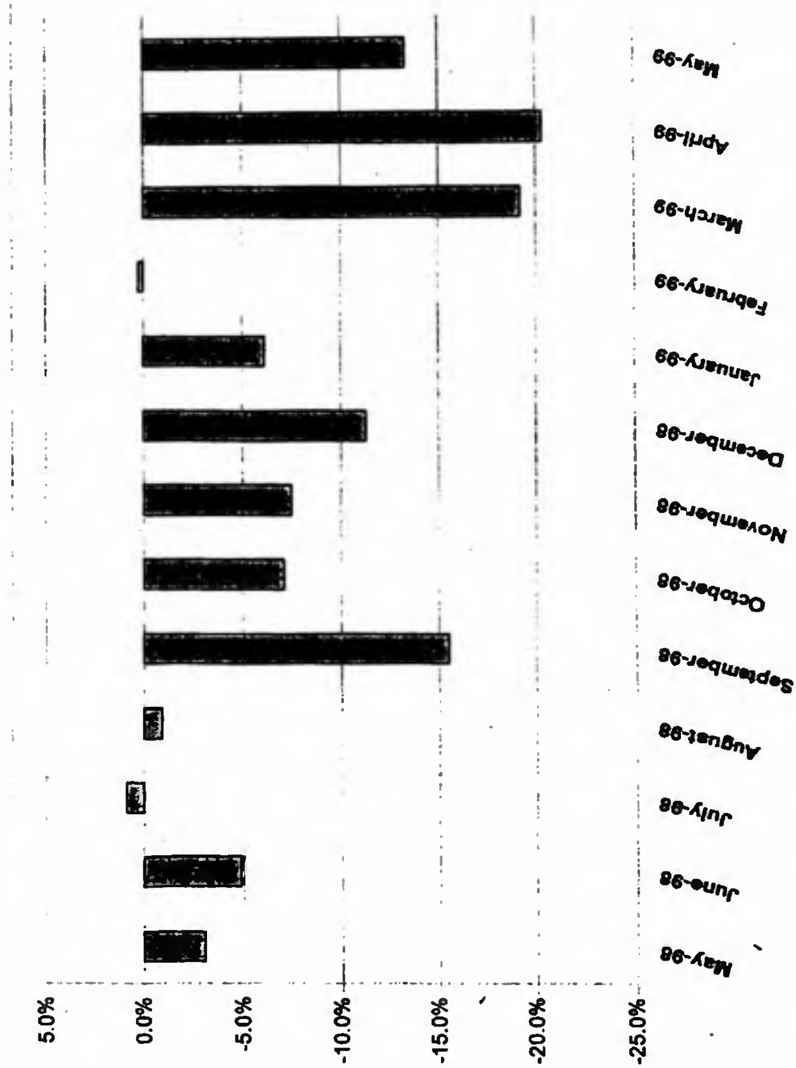
## Monthly Gross Sales

| | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|
| January | $22,700 | $21,604 | $22,729 | $21,335 |
| February | $21,342 | $24,042 | $19,993 | $20,042 |
| March | $24,064 | $26,087 | $26,041 | $21,037 |
| April | $24,428 | $27,693 | $29,815 | $23,757 |
| May | $32,261 | $35,093 | $34,032 | $29,499 |
| June | $34,059 | $33,046 | $31,438 | |
| July | $31,657 | $33,319 | $33,611 | |
| August | $33,734 | $33,487 | $33,192 | |
| September | $25,934 | $28,666 | $24,223 | |
| October | $22,450 | $22,536 | $20,939 | |
| November | $18,946 | $18,975 | $17,555 | |
| December | $18,445 | $18,520 | $16,428 | |
| **Year Totals** | $312,016 | $325,065 | $311,994 | $115,670 |
| **Annual Change** | | 4.18% | -4.02% | |

## Percentage Change

| | 1997 | 1998 | 1999 |
|---|---|---|---|
| January | -4.8% | 5.2% | -6.1% |
| February | 12.7% | -16.8% | 0.2% |
| March | 8.4% | -0.2% | -19.2% |
| April | 13.4% | 7.7% | -20.3% |
| May | 8.8% | -3.0% | -13.3% |
| June | -3.0% | -4.9% | |
| July | 5.3% | 0.9% | |
| August | -0.7% | -0.9% | |
| September | 10.5% | -15.5% | |
| October | 0.4% | -7.1% | |
| November | 0.2% | -7.5% | |
| December | 0.4% | -11.3% | |

Baskin Robbins Store # 30[illegible]5 Gross Sales 5/98 - 5/99



Mr. GEKAS.We thank the gentleman.
And we turn to Ms. Goodman for 5 minutes.

STATEMENT OF ARLEEN GOODMAN, GOODMAN & COMPANY, KAMPGROUNDS OF AMERICA FRANCHISEE ASSOCIATION, BRENTWOOD, TN

Ms. GOODMAN. Thank you. Good morning, Mr. Chairman, members of the subcommittee.

My name is Arleen Goodman, and I am here as a representative of the International Franchise Association, as well as my own franchise, Kampgrounds of America.

I have spent the last 24 years in franchising. I started out as a part-time employee, later became a manager, and then an owner of one of the larger KOA campgrounds in Nashville, Tennessee. And as past president of our national owners' association, I am deeply interested in protecting franchising for the benefit of others.

KOA is one of the oldest franchising companies in the Nation. Many of our current operating systems have become best practices within the world of franchising. We have about 1,000 franchisees as part of this system. Our franchisor was actually one of the first in the Nation to form an owners' association and then hand it over to its franchisees.

Before I chose to become actively involved in my system, however, I needed a wake-up call. There was a very divisive group of KOA owners who threatened to sue our franchisor for $50 million. Well, I knew then that as a long-term franchisee of the system, that if they were successful, if they were warranted in those accusation, my franchisor probably would not be able to withstand such a huge judgment. Should my franchisor become worthless, well, I would, too.

Not willing to sit on the sidelines, I chose an active role and served as one of a four-member team to mediate out the differences. To my knowledge, the programs we put in place from that open and frank discussion are still being used today within the system, and they are serving us well.

During my tenure as president of the KOA Owners Association, the State of Iowa took a giant leap toward legislating franchising contracts. Our KOA system was one of the first to notify the Governor of Iowa that we would no longer open franchised KOA's there. We felt the welcome mat for franchising business had been decidedly pulled.

While searching, I found no major organization representing the interests of franchisees—no where to turn for that perspective of the contract—so the KOA Owners Association became one of the founding members of the American Franchisee Association.

However, soon it became apparent that the interest of KOA owners, or in my opinion, those in other good systems, would not share an equal voice at the table of AFA.

Until 1992, the International Franchise Association had no provision for franchisee inclusion. But within the year, the opportunity became available for the first time. For the organization to have the desired meaningful voice of franchising, both parties had to have a place at any table of discussion. Our KOA owners' board embraced the invitation to join, and we became a founding member of the IFA Franchisee Advisory Council. Our decision rested solely upon this—no other group offered the possibility that franchisor and franchisee, alike, could come together and sit together. No longer was it them and us; it became "we."

Now, 5 years later, I have joined the ranks of other franchisees who have been recognized as leaders, and I have been elected to the full board of directors for IFA. Importantly, Steve Seigel, one of my co-founders of the American Franchisee Association, who also became a founding member of IFA's Franchisee Advisory Council, has been tapped into board leadership and will become the first franchisee chair of IFA in 3 years.

Franchise relationships are the Nation's largest system of small businesses. Franchisors are small businesses, too; 55 percent of franchisors have fewer than 50 franchise outlets. One-half, 53 percent, have 90 percent franchisee ownerships. Without a successful franchisor, there can be no successful franchisee, and without a successful franchisee, there is no successful franchise system. Our success is interwoven, and it relies in large part on open and frank communication between both franchisor and franchisee.

In our system of free enterprise, I believe the marketplace will ensure that the handful of franchise companies that operate with less than scrupulous business practices will not survive the scrutiny of serious business investors. That is why I believe that disclosure protection laws, rather than relationship laws, provide the greatest benefit to prospective franchise investors.

One thing I continue to be amazed about is the number of franchisees who simply sign on the dotted line. They have never read the contract; they have never consulted an attorney; and they have not studied other materials made available for this. No amount of legislation will ever protect or make successes out of those individuals.

Unfortunately, it is often the tragedy that makes the headlines, while the success stories go largely unnoticed. In that regard, franchising is like any other enterprise. There are successes, and there are failures, and there are no guarantees. But as I have said, the Federal Government cannot legislate a remedy to ensure that an investor becomes a success. I believe that further governmental regulations will create additional problems.

There are great opportunities in franchising for women and minorities, in particular. Franchising has provided an outlet for the creative energy for a whole generation of entrepreneurs in this country. Safeguarding franchising will continue to serve us well and safeguard that opportunity for future generations.

There has been a statement made that I would like to relate back to this closing. Franchisees are business men and women who want to be in business for themselves, but not by themselves. Therein lies the crux.

We look to the franchising companies to have a consistent experience that will be delivered to the public. That necessitates a lot of us doing things very similar all over the country. Leverage—we brought that up—that the franchisees have leverage. In my opinion, we have the greatest leverage. We have our signature, and whether we continue to put it on that contract will be the difference whether the opportunities are exceeding the risks, and so far, they are.

Thank you for your time.

[The prepared statement of Ms. Goodman follows:]

PREPARED STATEMENT OF ARLEEN GOODMAN, GOODMAN & COMPANY, KAMPGROUNDS OF AMERICA FRANCHISEE ASSOCIATION, BRENTWOOD, TN

Mr. Chairman and members of the Subcommittee, good morning. My name is Arleen Goodman, I am from Nashville Tennessee, and I am here today as a representative of the International Franchise Association (IFA).

I have spent the last 24 years in franchising. By all accounts, I would be labeled as successful. My career began as a part time employee, ascending to manager and ultimately owner of a franchise of KOA (Kampgrounds of America). I am proud to say that I came the first woman in 30 years to be elected President of the National KOA Owners Association and I am deeply interested in protecting franchising for the benefit of others who spend their days, and many times their evenings, working their own American Dreams.

KOA is one of the oldest franchising companies in the nation and currently has approximately 1000 franchisees. Many best practices in franchising have come from our system. Our franchisor was one of the first to actually form an owners association, then turn it over to its franchisees. Even though my campground ultimately had 150,000 visitors yearly, and was much larger than the typical campground, we are traditionally mom and pop small businesses.

Before I chose to become actively involved with my owners association, I needed a wakeup call. It came in the form of a divisive group circulating a rumor that they were putting together a fund to sue our franchisor for $50 million dollars. As a long time franchisee of the system, it became all too evident that if this group was warranted in their accusations, and a suit took place, not only would my franchisor possibly not be able to withstand such a judgement, but should the franchisor become worthless, so would my franchise. Not willing to sit on the sidelines, I chose an active role and served as one of a four-member team that mediated out our differences. To my knowledge, the programs we put in place are continuing to actively serve our franchise system well. As of today, channels of communication between the franchisor and its franchisees remain open.

During my tenure as president of the national KOA association, the state of Iowa took a giant leap toward legislating franchise agreements. Our KOA franchise system was one of the first to notify the governor of Iowa that we would no longer franchise in that state because of its actions. The welcome mat for franchising businesses had decidedly been removed. As president, I had no answer for the anguished face of a franchisee that pleaded with me as association president, "What are we going to do now? We've worked our whole lives, this is our retirement, and now KOA is not going to renew our franchise agreement." It became increasingly evident that franchisees needed information, as well as representation, about national issues. Iowa was only a state, but the nation was watching.

While searching, I found no major national association representing the interests of franchisees. No where to go for a perspective from this side of the contract. As a result, the KOA Owners Association became one of the founding members of the American Franchisee Association. We soon sought other information sources because that association became a home to franchisees predominately in very troubled systems. The interests of KOA owners, or in my opinion, those in other good systems, would not share an equal voice at the table of AFA.

At the time, the International Franchise Association had no provision for franchisee inclusion. But, within the year that opportunity became available for the first time. For the organization to have the desired meaningful voice of franchising, both parties had to have a place at any table of discussion. Our KOA owners' board embraced the invitation to join, and we became a founding member of the IFA Franchisee Advisory Council. Our decision rested solely upon this: No other group offered the possibility for franchisor and franchisee alike to sit together. No longer was it them and us. It became "we".

Now, five years later, I have joined the ranks of other franchisees recognized as leaders, and have been elected to the Board of Directors with the IFA. Importantly, Steve Seigel, one of my co-founders in the American Franchisee Association, who also became a founding member of the IFA's Franchisee Advisory Council, has been tapped into Board leadership and will become the first franchisee Chairman of IFA in three years.

I would be remiss in my remarks if I did not acknowledge the great strides of IFA in keeping its finger on the pulse on the evolving nature of franchising. Not only did IFA recognize the necessary inclusion of franchisees as part of its leadership structure; IFA has now begun to mirror what it expects its membership to reflect in the future. For the first time in its 39-year history, IFA has its first Chairman of color, Mr. Ronald Harrison, Vice President of Corporate Community Affairs at PepsiCo. No longer is franchising or IFA the white male dominated industry that some would have us believe. As a woman I am further proud to say that in the year 2000, JoAnne Shaw, President of Coffee Beanery Ltd. will succeed Mr. Harrison becoming the IFA's first woman Chairperson.

IFA is also proud to have an Emerging Markets Group, which is solely responsible for increasing the number of minority and women franchisors, franchisees and suppliers. These national programs are designed to develop mechanisms to increase the number of minority and female franchise owners by linking interested entrepreneurs with companies that are committed to supporting diversity. A series of Franchise Trade Delegations and Regional Educational Conferences to be held throughout the country will provide the forum for advancing these objectives.

Delegations have already been held in St. Louis, MO; Richmond, VA; Miami,FL; Washington, D.C. and Charlotte, NC.

In April of this year, the IFA signed a Memorandum of Understanding with the U.S. Small Business Administration. This agreement commits both organizations to encourage lending institutions to provide capital for creditworthy existing and prospective franchise owners in economically distressed areas. Goals outlined in this agreement are to increase the number and dollar volume of SBA guaranteed loans to franchisees in under-served markets, increase opportunities for eligible entrepreneurs, strengthen local economic and social infrastructures, and support sustainable economic growth.

As a member of the Women's Franchise Committee, I fully support IFA's Emerging Markets programs.

In 1995, I was selected to chair the Tennessee Delegation of 50 delegates to the White House Conference on Small Business. Some of my most vivid memories are about a session I attended there on franchising. The room was packed to capacity, because as delegates, we were being asked to carefully consider the top 60 issues facing small business. It was my opinion then, and my opinion now, that to send 60 issues to Congress for action was close to asking for the impossible.

Nevertheless, this was our charge. I vividly recall the room packed to the doors, standing room only because it was getting late and adjournment was near. I listened to what in my opinion was a stacked presentation on why relationship problems in franchising deserved government intervention. I was bold enough to suggest from the back of the room where I'd found a place to stand that more government is not always the answer, nor the best resolution. As I attempted to offer that there were many good systems, which needed to be taken into account in this discussion, I was literally booed into silence. While I had great compassion for the stories I heard in that room, there was no willingness to seek alternative answers. Obviously for my words to be interrupted, there was not even a willingness to consider alternatives. Many times we seem to be a nation bent on big brother solving a problem that may have not yet tried something simpler.

As an independent business owner, I know first hand the impact of additional government regulation, which may be designed to help, but which may result in additional hardships for small businessmen and women. As a small businesswoman and as leader of KOA's 1000 independent owners, I've seen the negative impact of federal regulation and the positive results of an open relationship between franchisors and franchisees.

As a leader within my state, I have spoken with others in systems with critical problems because communication wasn't there. And, I have seen the faces of those who have been given notice that they will no longer be allowed to operate a franchise because the state restrictions have choked off the air supply for the franchisor. I have listened to the voices on both sides of a discussion who have said this just isn't worth it anymore.

I urge you to use caution with this delicate balance as you proceed. Franchise relationships are just that. We are the nation's largest system of small businesses. Without a successful franchisor, there will be no successful franchisees. And without the success of the franchisee, there will be no successful franchise system. Our success is interwoven and relies in large part on open and frank communication between franchisors and franchisees. Thanks to modern technology, that kind of immediate and complete communication is now only an email or a phone call away. Good franchise systems prosper and grow because they seek out and listen to the opinions of their business partners—their franchisees. Unsuccessful franchise systems are just as likely to fail because of their failure to involve and rely on their franchisees for constructive criticism about how to operate the business.

I hope that at some point in the future, no potential franchisee would consider buying a franchise from a company that does not adhere to a Code of Ethics for fair conduct. There are many franchise companies from which to choose, and prospective franchisees should be diligent in investigating those many opportunities prior to making an investment in a franchise. In our system of free enterprise, I believe that the marketplace will ensure that the handful of franchise companies with less than scrupulous business practices will not survive the scrutiny of serious investors. That is why I believe that disclosure protection laws, rather than relationship laws, provide the greatest benefit to prospective franchise investors.

In preparing for what I might share with you today, I took advantage of the open and strong communication lines within the KOA system. I called the President of the company, and we chatted about the legislation in general, and specifically some of the reasons state legislatures and Congress have been asked to consider getting involved in contractual matters.

I'd like to share some of our conversation with you. KOA has always shared earnings information with prospective franchisees during the disclosure process. However, because the size of campgrounds varies significantly, so do the revenue figures for those campgrounds (depending upon size and location). And ultimately, a franchisee's earnings will depend largely npon the hard work and business acumen of the owner. But even a government mandate requiring disclosure of earnings claims, while well-intentioned, would lead to unreasonable reliance on that information hy prospective franchisees and create a disincentive to conduct a thorough evaluation of the investment. In the end, government regulation of any sort is no substitute for hard work, thorough investigation and a realistic appraisal of the investment (whether or not it is a franchise).

Secondly, KOA has for many years provided territorial protection for its franchisees. That is something that works for KOA, but that may not work for other franchise systems. I don't believe that we should ask the federal government to make business decisions about these kinds of issue, which relate to the particular industry and do not lend themselves to a uniform approach like federal legislation. While we see this kind of provision as a benefit to the system, it may not work in other systems. We shouldn't ask the federal government to unilaterally make those kinds of decisions.

We as a system feel there is an implied good faith and fair dealing when each party signs the contract. We also believe there are laws upon the books presently that can address prohlems that arise. We don't feel we need more laws. We simply need to enforce the ones on the books now. While some may claim an unwillingness, or inability to deal with them, laws exist. Fraud and mismanagement have no place in franchising; any more so than any other husiness contract.

Do we think additional federal franchise laws will harm our franchise system? Absolutely, especially if reliance on legislative remedies takes the place of communication within systems. And our system is a good example of an old company, which has survived because of leadership from both sides of the contract. Most importantly because we insist npon strong lines of communication. Any potential law which would hamper our ability to continue to do so, or any law which would suggest it is a respectable replacement for good franchise communications and practices would not be beneficial.

One thing I continue to be amazed about is the number of franchisees who simply sign on the dotted line without ever reading the contract, without ever consulting an attorney, or studying other materials before making a choice to huy the franchise. No amount of legislation will ever protect, or make successes, out of those individuals.

There are many of us who have an opinion about franchising, and I believe that my positive outlook is shared by the majority of those who have been involved with franchising. Unfortunately it is often the tragedy that makes headlines, while the success stories go largely unnoticed. I recognize that there are stories and examples of franchisees who have not been successful in their business ventures. In that regard, franchising is like any other enterprise—there are successes and there are failures, and there are no guarantees. But as I said before, the federal government cannot legislate a remedy to ensure that an investor makes a sound business decision. I believe that additional government regulation of franchise relationships would be a disaster for the largest segment of the small business community—franchising.

There are great opportunities in franchising, for women and minority entrepreneurs in particular. Franchising has provided an outlet for the creative energies of an entire generation of entrepreneurs. Safeguarding franchising will preserve this opportunity for the next generation of businessmen and women who want to be in business for themselves, but not by themselves.

As one who firmly believes that franchisors and franchisees must continue to work together to make franchising a successful enterprise, I want to thank you for inviting me here this morning.

Mr. BRYANT. [presiding.] Thank you, Ms. Goodman; and I certainly want to welcome you as a fellow Tennessean. I also want to invite our chairman to retake his lawful—[Laughter.]—position here, and would recognize Mr. Dunafon in the meantime for 5 minutes.

## STATEMENT OF DARRELL DUNAFON, DUNAFON REAL ESTATE DEVELOPMENT, SANDELLA'S FRANCHISE, FORMER TACO BELL FRANCHISE, JEFFERSON CITY, MO

Mr. DUNAFON. Thank you, Mr. Chairman, members of the committee.

I want to start before I do my presentation—and I believe in the room today is a Mr. Matt Shea, who is senior legal counsel for IFA. Yesterday, Mr. Bruce Major, who is senior vice president of franchising for Sandella's, received a phone call from Mr. Shea informing him that I would be testifying here today. And the reason for that call was to intimidate me from being here.

I now would like to go into my presentation.

Intimidations, threat, coercion, loss of support, insults, and, ultimately, exile is the price I paid for having the courage to speak for myself and nearly 90 percent of the other Taco Bell franchisees that were members of the International Association of Taco Bell Franchisees, when I was thrust into that leadership role of the organization in May 1993.

In less than 30 days, I went from a franchisee in good standing, a franchisee who, for 20 years, had grown the Taco Bell system in Jefferson City, Missouri, area, one who had met or exceeded the Taco Bell standards for sales and customer service, and had been a partner in Taco Bell developing some nine locations around central Missouri—it was their name and my money—to becoming a franchisee who, in the words of Taco Bell's then-chief executive officer and president, was labeled a "renegade" and a "scum," an unwelcome presence at a Taco Bell table, and, most critically, a franchisee who, despite meeting all objective criteria for opening of a new restaurant, was first denied the opportunity to expand my business, and then, ultimately, denied the opportunity to keep my business. And I was not the only one.

I became a Taco Bell franchisee in 1974. Over the next 18 years, I opened an additional 8 locations. Before 1990, it had always been Taco Bell's policy to allow expansion in the—give a franchisee objective criteria. And Taco Bell worked for the franchisee as though we were true partners in business.

In 1990, Taco Bell changed. They began dictating prices. They began experimenting with new concepts—kiosks, "Hot 'N Now"—encroaching on existing franchises. They also required us to purchase goods from the Taco Bell-approved supplier who, by the way, was PepsiCo Food Service, which was a parent company for Taco Bell. And they told us that our opinion was irrelevant, and that we were to get on the Taco Bell train or be left at the station.

The franchisees reacted to this. We formed an association. That association was the International Association of Taco Bell Franchisees. We, then, with legal counsel, joined the purchasing co-op in Louisville, Kentucky, and began pursuing an alternate vendor for our goods, and immediately enjoyed a 2 percent less cost for our cost of goods sold, showing us, as we had known for years, that we were getting arbitrary markups from our franchisor.

And we questioned Taco Bell's policies. Taco Bell wouldn't talk to us. Others were told that we were disloyal, the IATBF members, which included, by the way, 90 percent of all Taco Bell franchisees as dues-paying members. Now this isn't a renegade group. This isn't a group that doesn't have any support. Ninety percent of the Taco Bells franchisees, within a 6-month period of forming the association, paid dues and joined.

They began systematically targeting the leaders in an apparent effort to intimidate members of the IATBF. The very first president of the IATBF was Ron Bellamy. Ron Bellamy, before becoming a franchisee, had held senior management positions with Taco Bell. Yet, when he became a franchisee and became a recipient of the injustices that we were getting for years and realized how unfair they were, he felt so strongly that he was one of the forming members of the association and became the very first president. He was immediately denied growth. Ron Bellamy was ultimately bought out of the system by the corporation.

The Fowlers of Arkansas were denied growth. FRANMAC Corporation, a entity that held 100 Taco Bell franchisees, an excellent operator, was denied growth, all because of the active role we took in the association.

I was approved and ready to begin construction when Taco Bell stopped me because of my, quote, unquote, "attitude problem." I had a signed letter from a Taco Bell executive, dated June 1993, granting me operational and financial approval.

As a result of this and my inability to talk with anyone at Taco Bell Corporate, I initiated a lawsuit. And I have heard discussion about the choice of law—both, I think, two of our Congressmen used that discussion. Well, when I filed my Federal lawsuit, the Federal judge—and he ruled that the choice of law of California did not prevail in Missouri. Therefore, I did not get the privilege of the California law which would have given me the right of freedom of association. And that part of my Federal lawsuit was struck, effectively very much weakening my suit.

And I will try and wrap it up here, Mr. Chairman.

The case wore on for 5 years, costing me hundreds of thousands of dollars. Taco Bell, with its heavy-handed approach, came after us. We noticed up 5 fact depositions; they noticed up more than 20, including over 8 days of deposition of myself.

The case settled for an amount close to my out-of-pocket expenses. My losses were in the millions, and, most importantly, I was forced from my livelihood at a depressed price.

What Taco Bell did is not only did they deny me the growth, they, then, denied me renewal of my existing stores. And I had a store that was 6 months from renewal. I had negotiated a contract to offset that store in a new location. The vice president of franchising agreed with me that it was a good business decision to do that.

It was in the best interest of Taco Bell and myself to do that, but said, "We are not going to let you do it unless you drop your lawsuit." I was, then, forced to sell my business as opposed to losing that equity.

Federal legislation would have helped me and thousands like me—franchisees who find out too late that their franchisor refuses to act fairly and in good faith.

I would implore you to sincerely look for standards that could alleviate situations that happened to me. Now I have been denied my business; I loved what I did.

And I applaud Ms. Goodman and Mr. Adler for their comments. I am glad they are in good concepts, and I am glad they act fairly. And I wish everybody would, but they don't, and that is why we have laws, and that is why we need laws.

Thank you.

[The prepared statement of Mr. Dunafon follows:]

PREPARED STATEMENT OF DARRELL DUNAFON, DUNAFON REAL ESTATE DEVELOPMENT, SANDELLA'S FRANCHISE, FORMER TACO BELL FRANCHISE, JEFFERSON CITY, MO

Intimidation, threats, coercion, loss of support, insults, and ultimately, exile—that is the price I paid for having the courage to speak for myself and nearly 90% of the other Taco Bell franchisees that were members of the International Association of Taco Bell Franchisees ("IATBF") when I was thrust into the leadership role of the organization in May of 1993. In less than 30 days, I went *from* a franchisee in good standing, a franchisee who, for 20 years, had grown the Taco Bell name in Jefferson City, Missouri area, one who had met or exceeded Taco Bell's standards for sales and customer service and had been a partner with Taco Bell in developing some nine locations around central Missouri (with their name and my money), *to* a franchisee who, in the words of Taco Bell's then Chief Executive Officer and President was a "renegade" and "scum," an unwelcome presence at the Taco Bell table, and most critically, a franchisee who, despite meeting all objective criteria for the opening of a new restaurant, was first denied the opportunity to expand my business, and then, ultimately, denied the opportunity to keep my business. And I was not the only one.

Moreover, because federal legislation that would, among other things, prevent a franchisor like Taco Bell from seeking to deny franchisees the right to associate does not exist, Taco Bell was ultimately successful in its campaign to destroy the IATBF.

I opened my first Taco Bell Restaurant on January 27, 1974, in Jefferson City, Missouri. For nearly 24 years, I had an exemplary financial and operating history as a Taco Bell franchisee, with average annual sales at each of my locations (some of which are located in unusually small communities), consistently above the national average. The written Franchise Agreements for these locations stated that they were for a 20 year term.

In 1990, Taco Bell sponsored a meeting between its franchisees and Taco Bell management executives at Vail, Colorado. At that meeting, Taco Bell's President and CEO informed the Taco Bell franchise community that he alone would determine Taco Bell's policies and procedures regarding pricing and marketing. He further stated that Taco Bell franchisees would be required to adhere strictly to his mandates and would have no say in the direction of Taco Bell's future. Taco Bell's emphasis on marketing a three-tiered "value menu" was a hotly contested issue with many franchisees, as we all believed that it threatened to significantly reduce the profitability of our franchises. Additionally, Taco Bell intended to pursue aggressive market penetration through the promotion of new nontraditional, non-restaurant distribution points including movable food carts, kiosks, concession-like facilities, and even vending machines. Many franchisees were concerned that such an emphasis would result in a significant reduction of their customer base and would create overlapping markets. Additionally, many franchisees were alarmed that Taco Bell was test marketing these nontraditional distribution systems by using outside contractors, such as Marriott, rather than permitting franchisees the opportunity to develop these systems. At the Vail meeting, it was made clear to the attending franchisees that Taco Bell franchisees' concerns would not be considered by Taco Bell.

Taco Bell subsequently sent a letter to franchisees that had not attended the Vail meeting which informed them that their nonattendance at the meeting for any reason other than a dire emergency was taken by Taco Bell to be an indication that the non-attending franchisees had a different strategy for the future of the Taco Bell system than Taco Bell and Taco Bell representatives would be meeting with them within thirty days to discuss their leaving the Taco Bell system.

As a result of the statements to the franchisees at Vail, the letter that followed, and the failure of the company controlled franchise association ("FRANMAC") to disclose to franchisees new pricing programs being developed, tested and implemented by Taco Bell, a large number of Taco Bell franchisees determined that an independent franchisee association for the Taco Bell community was needed.

The Independent Taco Bell Franchisee Association, IATBF, was formally incorporated in January 1992. Its mission was to provide a forum for franchisees within the Taco Bell franchise community to address their concerns regarding Taco Bell policies and procedures and the relationship between Taco Bell and its franchisees and to protect franchisees' investments in the Taco Bell system and their interests in growth opportunities. IATBF consisted of six autonomous regions, each with its own board of directors and bylaws, and a national board composed of the presidents of the six regions. At its inception, franchisee membership in IATBF consisted of approximately 90% of all U.S. Taco Bell franchisees. It was not, as Taco Bell liked to say, a group of small "renegades" or "scum."

IATBF polled its regional constituency and determined the following issues, among others, were major concerns in all regions: clearly established any written criteria for expansion into additional franchises; new product development; system documentation; encroachment of existing franchises by the promotion of nontraditional distribution points; advertising which reflected tiered "value menu" promotions which not all franchisees had implemented; policies for transfer, termination and renewal of franchises; brand marketing; and independent, competitive sources of supplies and equipment. IATBF facilitated the communication and discussion of these issues among its constituency at regional and national meetings, and by the use of letters and a magazine called "Newsline." IATBF surveyed its members and then communicated its position regarding various Taco Bell pricing and marketing policies to Taco Bell by submitting written proposals to Taco Bell executives. Taco Bell's President, however, refused to acknowledge the existence of IATBF and refused to negotiate with it directly.

From its very inception, Taco Bell treated the leadership of the IATBF with hostility and acrimony. In fact, Taco Bell's President expressly told attendees of a FRANMAC meeting occurring in February 1993 that the leaders of IATBF would not be permitted to grow within the Taco Bell system. Taco Bell's President repeatedly characterized the IATBF leadership as "scum" and renegade franchisees. Such representations to Taco Bell franchisees by Taco Bell appeared to be intentionally calculated to reduce the effectiveness of IATBF by belittling its leaders and intimidating other franchisees into leaving, or not joining, the independent association.

IATBF aggressively pursued the harmonious and business-like resolution of numerous issues with Taco Bell management, including without limitation: the encroachment of franchisees' business base by corporate-owned and licensed restaurants and the possibility of substantial encroachment through Taco Bell's development of the Hot 'n Now hamburger chain which targeted the same customer base; tier pricing systems and value-priced menus; and the T.A.C.O. program which provided Taco Bell direct computer access to franchisees' sales and proprietary financial information.

Taco Bell resented being confronted on these and other issues by a large and unified body of franchisees. Accordingly, one by one, Taco Bell attacked the vocal leadership of the IATBF by denying them, individually, the ability to expand and develop new Taco Bell franchises.

Ron Bellamy was the first President of IATBF. Bellamy, with his wife, Helen, and their corporation, Kawara, Inc., operated seven Taco Bell franchises in Wichita Falls, Texas. Before becoming a Taco Bell franchisee and assuming the IATBF leadership, Bellamy had several positions with Taco Bell. During his four and one-half year tenure at Taco Bell, Mr. Bellamy held senior executive positions with responsibilities, at various times, for operations and franchising, real estate and construction, and as Chief Financial Officer.

As President of IATBF, Mr. Bellamy was an aggressive and vocal advocate of franchisee interests, which necessarily involved some criticism of many of Taco Bell's policies and practices. During his tenure as IATBF President, the association successfully negotiated arrangements for Taco Bell franchisees who so desired to purchase supplies from an independent purchasing cooperative (rather than the former PepsiCo controlled supplier, who was then an affiliate of Taco Bell).

In August of 1992, Mr. Bellamy requested Taco Bell's approval to develop a new Taco Bell restaurant. In a letter dated August 12, 1992, Taco Bell's National Vice President of Franchise Operations informed him that, although he was financially and operationally qualified for new store development, Taco Bell had made a "judgment call" that "based on our working relationship with the franchisee," the "fit" of the proposed franchise within the system, and "other factors," Bellamy would not be permitted to expand. On August 18, 1992, Bellamy was told by his Franchise Business Manager that Bellamy had been denied growth because of his involvement with IATBF.

At an IATBF national meeting in San Antonio in October 1992, a portion of the constituency of IATBF proposed that the association back off on its external communications efforts to let relations between it and Taco Bell cool down and to determine what results had been accomplished. To preserve the integrity of IATBF, Bellamy substantially ceased talking to the media about Taco Bell in January 1993. On April 19, 1993, Taco Bell approved Bellamy's application for a successor agreement (renewal) of an existing restaurant in Altus, Oklahoma. Taco Bell permitted Bellamy's expansion because he had ceased openly and vocally challenging Taco Bell's policies for a period of several months. Mr. Bellamy resigned from his leadership position with IATBF on May 27, 1993 approximately seven months before the end of his term of office.

Wallace Fowler, a multiple franchise operator located in Jonesboro, Arkansas, was a regional president of the IATBF and its national treasurer. Mr. Fowler's son, Chris Fowler, is an independent Taco Bell franchisee for the sole franchise located in Jonesboro, and is a joint-franchisee with his father on six others. Chris Fowler was a member, although not an officer, of IATBF. Wallace Fowler openly and publicly criticized Taco Bell's proposed development of a corporate restaurant in the small town of Jonesboro as unwarranted and unfair encroachment into the customer base of Chris Fowler's franchised restaurant in Jonesboro.

At a FRANMAC meeting in San Antonio, Texas in October 1992, Taco Bell's National Vice President of Franchise Operations, informed both Wallace and Chris Fowler that they would not be permitted to develop any new franchises because of Wallace Fowler's involvement with IATBF and because of his public statements to the media critical of Taco Bell. They were further told that if they ceased making any public statements for a period of six months, Taco Bell would reconsider its position regarding their expansion.

Chris Fowler was the President of the Arkansas Restaurant Association in 1992. In that capacity, Chris Fowler lobbied the 1992 session of the Arkansas legislature to seek franchise reform legislation. A representative of PepsiCo lobbied against the legislation. Following this activity, a Taco Bell Franchise Business Manager informed Chris Fowler that such political activity would not be tolerated by Taco Bell and would result in the continued denial of either Chris or Wallace Fowlers' requests for growth within the Taco Bell system.

On March 19, 1993, several months before I assumed a leadership position with the IATBF National Board, I negotiated with developers for the purchase of land at a retail development center in Holts Summit, Missouri (Old Highway 54 and Missouri Route OO). Thereafter, on May 27, 1993, with the resignation of Ron Bellamy, I assumed the position of Chairman of the Executive Committee of the IATBF.

On June 2, 1993, the Taco Bell Franchise Coordinator of Franchise Administration informed me by letter that I was financially and operationally approved for the new franchise development. Financial approval would remain valid for a one year period (expiring May 26, 1994) and operational approval would remain valid for a six month period (expiring September 3, 1993). The letter further stated that "[s]hould there be an unfavorable change in your financial or operational situation, this approval will be revoked." No change in my financial or operational situation occurred between June and September 1993. The only change was Taco Bell becoming aware of my assumption of leadership of the position as IATBF's Executive Chairman.

On July 12, 1993, Taco Bell furnished me with two Taco Bell Franchise Direct Development applications, release forms and confidentiality agreement. I executed these documents and returned them to Taco Bell.

By letter dated July 12, 1993, Taco Bell's Executive Vice President of Franchise Operations informed me that I was denied expansion approval for the Holts Summit franchise.

By a letter dated July 26, 1993, Taco Bell's Director of Franchise Administration informed me that, pursuant to Taco Bell's July 12, 1993 letter denying expansion approval, Taco Bell would not accept *any* new site proposals from me nor would it consider me eligible for any franchise approval.

In addition to Taco Bell's conduct in denying approval for the Holts Summit expansion, Taco Bell virtually abandoned its efforts to provide the corporate support Taco Bell was contractually obligated to provide in the written Franchise Agreement.

As a result, with the financial backing of the IATBF, I filed suit and asked Taco Bell to mediate my claims through the newly formed Center for Public Resources ("CPR"). As I understood at the time, CPR was an organization, formed by the nation's largest franchisors (including Taco Bell), for the purpose of providing an alternative dispute mechanism that would decrease or eliminate the need for legislation to help resolve legitimate franchisee claims. I regret to inform the Committee that Taco Bell flatly rejected my request to mediate (despite the fact that Taco Bell, as a founding member of CPR, had pledged to mediate any disputes with franchisees, and despite CPR's assurances that its members would be required to mediate such disputes).

After the initial suit was commenced, I continued to fulfill all of my obligations under my franchise agreements. In 1996, I reached terms with my landlord that would allow me to construct a new Taco Bell restaurant in Rolla, Missouri, on land across the street from a Taco Bell that I had owned and operated since 1978. However, before beginning construction, I complied with my obligations under the Franchise Agreement and sought the approval of Taco Bell for both the new location and "Successor Agreement" for the Rolla site.

Despite the expressed criteria, and the previous approval of my franchise operations, during a telephone conversation on August 13, 1996, Taco Bell's National Vice President of Franchise Operations informed me that I was being denied a Successor Agreement and the opportunity to re-build in Rolla.

During the course of that conversation, this Taco Bell executive mentioned, on several occasions, that he believed the re-build and Successor Agreement made "good business sense" and that there was no business reason for denial of the re-build and Successor Agreement. However, he went on to inform me that, because I had exercised my legal rights in an attempt to force Taco Bell to live up to its contractual commitments regarding new Taco Bell franchises, Taco Bell was not willing to grant me a Successor Agreement. The effect of this decision was to deprive me of all of the "going-concern" value I had built up in Rolla for both my location and the Taco Bell name. Indeed, Taco Bell acknowledged to me that this decision was contrary to Taco Bell's best interests. The Vice President of Franchise Operations told me that he agreed that "[myself] and Taco Bell would financially benefit from the location and new building" and that if I dropped my lawsuit, Flanagan would be "willing to reconsider [my] proposal for relocation and a Successor Franchise Agreement." Because I believed that I had an obligation to myself, to my family, and to the thousands of other Taco Ball franchisees to help protect the basic right of association, I rejected Taco Bell's "offer."

In 1997, recognizing that I had no future with Taco Bell (as my franchise agreements would lapse one by one, leaving me with no viable operation), I sold those Taco Bell-related assets I had left. The expert I retained for trial opined that the value of the sale was decreased by over 1.5 million dollars as a result of Taco Bell's conduct. My sale also removed me as a member of IATBF (as I was no longer a franchisee). By late 1997, and based in large measure on the failure of the organization to attract assertive leadership, the IATBF ceased operations.

While I settled my case after a day and a half of trial in August of 1998, I can tell the Committee that the amount I received was an amount roughly equivalent to the costs and expenses (including attorneys' fees) I expended over the course of the litigation—an amount that was significantly less than the decreased value at which I was forced to sell my business. In short, I was driven from the system, had my livelihood taken from me, and was paid a depressed price on the value of my business, all because Taco Bell was not prevented from acting to deny the free association of franchisees—a basic right most Americans would be surprised they don't have in their business relationships.

Ironically, my Franchise Agreements had a California choice of law. If the court had seen fit to enforce the California choice of law, I would have received the benefit of California's protection of a franchisee's right to the freedom of association. However, the court determined that Missouri law controlled my claim, and therefore, my claim for Taco Bell's denial of my right to free association was dismissed prior to trial.

My experience demonstrates the need for the legislation which is currently pending—legislation which is definitely needed to level the playing field and make explicit that which business people know (but which some courts and franchisors have refused to acknowledge): franchisors and franchisees, in their dealings with each other, need to deal with each other fairly, in good faith, and in a commercially reasonable manner. In short, the minimum standards of acceptable conduct that are represented by this legislation are sorely needed.

I thank the Committee for their time, and am hopeful that my ordeal will help the Committee in recognizing the value of this long overdue legislation.

Mr. GEKAS.[presiding] We thank you, Mr. Dunafon.

We turn to Doc, to Mr. Cohen.

## STATEMENT OF LAWRENCE "DOC" COHEN, PRESIDENT AND CEO, DOC AND ASSOCIATES, HOUSTON, TX

Mr. COHEN. Well, last, but hopefully not least—Mr. Chairman, members of the committee, I have a slightly different story.

Twenty years ago, I was a senior executive of a chain of drugstores that made a decision to do what we, today, call corporate downsizing." I was an early victim of corporate downsizing, only in those days, I just called it "getting fired."

I had no money; I had no job, but I happened to see a store in a regional mall in Atlanta, Georgia, selling chocolate chip cookies. There were people lined up around the mall waiting to buy them. And I said, "You know, I think that is what I want to do." I have been mixing drugs all my life; I think now I want to mix dough. And, in fact, I wish I were home today making dough. With all due respect to this procedure, it would be a lot more profitable. [Laughter.]

I had no idea what franchising was all about; there was no FTC rule. There was no regulation, or little regulation. But I decided that I was going to go forward with this, and I became a franchisee of the Great American Chocolate Chip Cookie Company.

They were a new system. I didn't know how to be a franchisee, and they, frankly, didn't know how to be a franchisor. [Laughter.]

And that was pretty good for me, because they didn't ask to see my financial statement. And if they had, I probably would not be sitting here today—[Laughter.]—because I didn't have a financial statement.

Over the course of 19 years, I managed to open 35 stores in 7 States, created 300 new jobs, and grew the company to over $10 million in sales, which, as I understand, ranks my company larger than probably 70 percent of the franchisors in the country.

But not every store was successful. My first store was very successful. The second one was pretty good, but more average. The third store was a disaster and almost put me into bankruptcy. I was the only chocolate chip cookie store in the Nation anchoring a regional shopping center. [Laughter.]

It would have been easy for me to blame my franchisor for picking this dynamic location. It would have been easy for me to blame them for the failure of the store which was doing, I think, a grand total of $70,000 a year in sales. But I didn't blame them; I was equally involved in the decision. I was in business; I should have gotten better advice, and I should have been a little bit smarter.

Instead, I worked with my franchisor and worked with the landlord, and we worked things out—deferred rents, deferred fees until the store finally became successful. It was just a bad business decision. It wasn't anybody's faulty necessarily.

When I joined Great American, I read a 70-page franchise document which I considered extremely one-sided, just as most franchise agreements appear to be, from the testimony I have heard here today. I didn't like it one bit. My attorney said, "Don't sign it." But I wanted to be in franchising, and I wanted to be in my own business, and I wanted to achieve my American dream. And so I did sign that agreement.

I was glad, years later, that the agreement was as strong as it was, because the franchisor needed that agreement and needed the strength that it gave him to enforce the system's standards which later protected me and my business. It kept people who did not belong in franchising and who were not running their stores up to standards from being in the system, and gave the franchisor the tools it needed to enforce the standards that protected me and all of the other franchisees in my system.

Eventually, we had—our system grew, and we had more and more franchisees, and we started to get into all of the similar arguments that these other folks have testified to with our franchisor. And we argued and argued about everything we could think of for 5 years. And then we said to ourselves, as franchisees, "We need a better vehicle." And so we formed a Franchisee Advisory Council. Then, we spent the next 2 years arguing some more, until we had finally realized we had argued about everything there was to argue about, and we started looking, instead, at some constructive things that would help our businesses.

And so we started talking about, how did we improve our stores? How do we improve construction? How do we improve our product line? And you know what happened? It was really amazing. Our sales started to go up; the cost of our goods went down. Our marketing improved. Our product line expanded and improved. And, you know what? We all started making a lot more money. And when we started making more money, the arguing went away, because we found we didn't have anything more to argue about.

Six years ago, the IFA opened its membership to franchisees, and I am proud to be one of the founding members of IFA's Franchisees Advisory Council, and last year served as chair of that council, sat on the board of directors and on the IFA's executive committee. I had exposure during the IFA to people in other systems—franchisees and franchisors from all walks of life and all walks of American business. And it was here that I learned what the true nature of franchising is.

Franchising is a partnership in every sense of the word, except the legal. It is a responsibility of both parties to help each other be successful, but not necessarily at each other's expense.

Franchisees have to assume some of the responsibility. While franchisors provide the framework, the franchisee also needs to make a contribution and do what they need to do to help protect the system.

In 1997, I woke up one morning to what I thought was going to be my worst nightmare, but turned out to be a very pleasant dream. We found out that our chief competitor, Mrs. Fields Cookies, was about to buy our system.

Instead of panicking, we sat down with the franchisor—both ours and Mrs. Fields—and we worked out an agreement as to how our system would be governed and how our brand and our system would be protected. And it just proves what can happen when good people sit down at a table and have honest and frank discussions with each other. And we worked it out, and 2 years later, we are very happy with the deal.

In closing, I have to tell you that franchising has enabled me to achieve my American dream. I do not believe that government can legislate success. It can and does require and regulate full disclosure. I don't believe it should interfere or attempt to regulate private contractual rights of the parties. Franchisees, contrary to some opinion, do have a great deal of leverage with their franchisors. We are the ones that recommend the system to other franchisees, and we are the ones that control growth.

I hope that you will agree and not enact any further legislation.

Thank you very much.

[The prepared statement of Mr. Cohen follows:]

PREPARED STATEMENT OF LAWRENCE "DOC" COHEN, PRESIDENT AND CEO, DOC AND ASSOCIATES, HOUSTON, TX

Good morning, Mr. Chairman and members of the Committee.

I began my career in franchising 20 years ago when I became one of the earliest victims of "corporate downsizing." Of course, in 1978 we just called it "getting fired."

Through pure chance, I saw a store in a shopping mall in Atlanta, Ga. selling chocolate chip cookies. There were lines of people queued up to buy the cookies and I thought that I might like to get in on what appeared to be the proverbial "Gold Mine."

This was a very new business concept and it was difficult to obtain much information about the success of cookie stores since, outside of California, there were very few of them in existence. However, as a resident of California at the time, I set out to visit as many of those locations as I could find and finally decided to pursue obtaining a franchise from the Great American Cookie Co.

For someone who was accustomed to receiving a paycheck every week from a corporate payroll department, this was a very scary decision. Do you know how many 29-cent cookies you have to sell to pay the rent in one of those regional malls?

Undaunted by the fear of that question, and by the way, without having the answer to it, I pushed forward with my quest to become a franchisee and with the pursuit of my American dream of owning my own business. I never thought about investigating franchising to see if it was a legitimate means of doing business. In those days, there was no FTC Franchise Rule, no federal requirement of pre-sale disclosure by franchise companies to prospective investors. But I pushed forward just the same.

Great American Cookie Co. agreed to sell me a franchise and promised me that I could have the entire state of California. Fortunately, they never asked to see my financial statement or I would most likely not be sitting here today. I didn't have a dime to my name. I spent the next 3 months looking for a location for my first store and finally obtained one in a new mall being built in Mission Viejo, about 20 minutes from my home. I was elated, and boarded the first plane I could get to Atlanta to sign my franchise agreement. My life was about to change, but not in the way that I had planned. The franchisor informed me that they had just realized that California DID have a disclosure law and that they had not registered in the State. Therefore, they could not sell me the franchise for a store in California. This is how I was introduced to the world of franchising.

This was a traumatic experience, but I was not willing to give up my dream. As things turned out, I bought a franchise to open a store in a new mall in Lafayette, Louisiana and moved there to build and operate the business. Huntington Beach, Ca. to Lafayette, La.—talk about your culture shock. But Lafayette was good to me. I loved the city, I loved Louisiana, I loved the people and they loved my cookies. The rest is history. I went on to open 35 units of Great American Cookie stores, earning gross sales beyond my expectations and creating 300 new jobs along the way.

In the process, I learned a great deal about franchising. Franchising is not an industry—it is a means of distribution, one of many ways of doing business. It involves an agreement between two parties who contract to do business together. That contract sets out the various obligations and responsibilities of each party. It states that the franchisor will provide certain services and that the franchisee will live up to certain requirements that are designed to protect the franchisor's brand, products, reputation and the franchise system itself. *It does not guarantee that either party will make a profit from the relationship.*

My attorney told me that the agreement I was being asked to sign was extremely one-sided and that he could not advise me to sign it because the contract gave the franchisor too much control. I think the word my attorney used to describe the document was "onerous." I read the agreement. I had the benefit of legal counsel. I understood the agreement and my obligations. No one forced me to sign that contract. I could have walked away, but I decided to go forward—my dream was not going to be denied.

My first store was very successful and 8 months later I opened my second unit, which was also a winner. Within a year, I opened unit number 3. This one nearly put me into bankruptcy. It was then that I learned the meaning of the word "onerous." There was little I could do to get out of the losing store. The contract was "iron clad" and could not be broken without risking the loss of my two profitable stores. But I knew then, just as I know now, that the true essence of a franchise agreement is that of a partnership, a kind of marriage where the parties need to rely on each other and to help each other.

I went to my franchisor and told them of my situation. I asked for their help and they agreed to help me. Together, we went to the landlord and worked out an abatement of rent. The franchisor reduced and deferred my fees and I was eventually able to turn that store around. Today, it is one of the best stores in the group.

This was an important lesson for me, because it was the first time that I really understood the real nature of the franchise relationship. In the years that followed, the Great American system grew rapidly. As more franchisees came into the system, we began to have more issues arise between us and our franchisor. There were times when the relationship bordered on adversarial, but we continued to work within our system to identify and solve the problems that we had.

In 1985 we established a Franchisee Advisory Council to work with management to address issues, and while it was not easy, we were able to accomplish changes in our system that made the system better. Many of these were serious issues that dealt with provisions of our contract, but by continuing to communicate, we were able to solve most of the problems that we encountered.

In 1996, Great American Cookie Co. made a decision to allow representatives of our franchisee association work with them to rewrite our franchise contract. We spent a year on the project and ended up with a document which was much more practical and which adequately protected the rights of all parties. We did all of this without the need to use the courts, without the need to file grievances with state or federal agencies, and without the need to seek government regulation.

Looking back, I see now that both the franchisor and franchisees were maturing, as our businesses grew. As a result of this growth and changes taking place, we encountered issues that could not have been anticipated at the beginning of our relationship. But the key to our success was mutual respect and cooperation, something that you really cannot legislate. Each franchise system, as it grows and changes, will encounter such issues, and the franchisor and franchisees must work together if they want to succeed.

I believe, and my experience confirms, that good people, who share common goals, can sit down together to work out differences that may seem to put the parties worlds apart.

I can think of no better example of this than a series of events that began, for me, on July 1, 1997. On that day, I woke up to what I thought would be my worst nightmare. I received a telephone call asking if I had heard a rumor that Great American Cookies was about to be purchased by Mrs. Fields Cookies—our chief competitor. I could not imagine a worse situation. Nineteen years of fighting with them for market share and locations. Nineteen years of effort to build the Great American chain into one of the great franchise systems in the world. Nineteen years of relationship building about to be destroyed.

But that nightmare turned into pleasant dreams. Management at Mrs. Fields worked with the leadership of our franchisee association and addressed our fears and concerns. We talked about our issues, about the pride we had in our brand and product, about overlapping markets, about support and marketing. We did not agree on every issue that we discussed, but we did agree on most. We were able to turn that agreement into a written document, and now, almost a year later, we are still very pleased to be a part of the Mrs. Fields System and the increased opportunities that the merger provided to our franchisees.

It is important to note that neither Mrs. Fields nor Great American Cookies had any contractual or legal obligation to talk to the franchisees about the merger of the two entities. Our franchise contract provided no rights to the franchisees in matters of the sale or merger of the franchisor. However, because the parties recognized the importance of the relationship, they were willing to address the concerns raised by the franchisees. This is the nature of franchising. Communication between the parties is essential to maintaining the relationship.

Six years ago, at the request of Great American Cookie Co., I became a member of the International Franchise Association (IFA). I was asked to serve on IFA's Franchisee Advisory Council (FAC) and represented that council on numerous IFA committees. I served on and became vice chair of the Franchise Relations Committee, served on and became vice chair of the Awards Committee. Last year I served as chair of the Franchisee Advisory Council and in that capacity became a voting member of IFA's Executive Committee and Board of Directors. Serving on the FAC has allowed me to meet leaders from many of the country's most recognized franchise systems including McDonald's, Burger King, Wendy's, Uniglobe Travel, Holiday Inn, Jani King, Dairy Queen, Mail Boxes, Etc., Kwik Kopy, Cendant, Tricon and others.

During my term as chair, I visited the annual conventions of 15 franchise companies and spoke to their franchisees. Working with so many people in so many systems and getting to know both franchisors and franchisees has convinced me that people can and do work together to improve their businesses.

I am convinced that the current federal and state laws that require pre-sale disclosure by a franchisor to a prospective franchisee are sufficient to enable people to make informed decisions before investing in a franchise. I do not believe that federal legislation is needed and would oppose any type of legislation, federal or state, that would attempt to regulate or interfere with the ability of private parties to enter into a contractual relationship. I have the benefit of legal counsel to advise me on those issues. It is important to recognize that each system is unique and that contracts must be written to reflect those differences. Maintaining system standards, brand integrity and the value of the franchisee's investment is critical. Each system must have a contract that protects those essential elements of a franchise. Attempts to prescribe by law what franchise contracts must contain, and what they cannot contain, would only undermine one of franchising's greatest strengths—which is its flexibility and adaptability to fit many different types of businesses.

I do believe that franchising works because hard working people establish bonds of trust and relationships that enable them to work together toward a common goal. Franchisees have as much responsibility to further that relationship as do franchisors. While franchisors bear most of the responsibility for supporting the system, I believe that franchisees have an obligation to contribute as well—to give something back—to assist the franchisor whenever possible to make the system better and more successful.

The marketplace is the final test for franchising, and for each franchise system. When I look around at the hundreds of thousands of businesses that have developed, grown and prospered, I can only conclude that it must be working pretty well, most of the time, if not all of the time. Good franchise systems succeed when they build excellent relationships with their customers, employees and franchisees. The marketplace rewards these franchise systems with more customers, more employees and more franchisees. Franchisors cannot succeed without successful franchisees, and a franchisee cannot succeed without a strong and successful franchisor. We need each other.

At Great American Cookies, I was a founder of our Franchisee Advisory Council, was a founder of our Independent Franchisee Association and acted as unofficial "ombudsman" for 19 years. During the last five years, I have helped other systems establish advisory councils or associations and have consulted with several systems on the issues of franchise relations. I believe that my experience qualifies me to make an informed judgment about the health of franchising. Franchising has made it possible for millions of people to achieve their "American Dream." Do we need further regulation or legislation to change it?

I think not.

Thank you for inviting me to make these remarks this morning.

Mr. GEKAS. We thank the gentleman.

It now comes time for the members of the committee to ask questions, and for that purpose, the Chair now yields itself 5 minutes for the first round of questioning.

Mr. Adler seemed to have indicated that the predisclosure aspect of franchising, on the part of the franchisor, is pretty adequate. It is pretty good. That is the implication I received from his testimony.

While Ms. Kezios says—and has the charts to indicate it, I thought—that it is not, that it is not adequate predisclosure.

Therein lies some of the conflict with which we have to deal, because I thought that one of the basic problems in this whole area was the predisclosure. Did the franchisee know what it was getting into, is one of the main concerns.

How do we reconcile that?

Mr. ADLER. Could it be that she is uncharacteristically wrong?

Mr. GEKAS.Pardon me? [Laughter.]

Ms. KEZIOS. Absolutely not. [Laughter.]

There are a couple of answers to that question, Mr. Chairman.

One, the Federal Trade Commission's presale disclosure rule has to do with presale issues, not post-sale. While many problems remain to be resolved regarding presale disclosure, the external issues for current franchisees involve abuses within the ongoing franchise relationship.

Mr. GEKAS.Okay.

Ms. KEZIOS. Post-sale.

Mr. GEKAS.I get it. In other words, there is no big "beef"—maybe that is the wrong word to use.

Ms. KEZIOS. Yes. Or "slouvaki," maybe.

Mr. GEKAS.But maybe no— —

Ms. KEZIOS. Yes. [Laughter.]

Mr. GEKAS. [continuing]. Real complaint about presale disclosure, meaning that when the franchisee enters into the contract, that there is perhaps an agreement that we have some adequate disclosure there?

Ms. KEZIOS. With presale, our biggest problem is that there is no private right of action under the FTC rule. And in both Mr. Coble's proposals and in Mr. LaFalce's proposals from previous Congresses, there was a private right of action given to franchisees, under the Federal Trade Commission rule.

Right now, franchisees in 30-odd States have to go to the Federal Government to get any redress on their behalf, if they believe that the franchisor has violated the presale disclosure requirements of the Federal Trade Commission.

And in 1992, the General Accounting Office audited the FTC's enforcement of the rule on franchising. The GAO found that the FTC acted on less than 6 percent of all franchise complaints brought to it relative to presale, having nothing to do with post-sale.

Mr. GEKAS.Did State courts have any jurisdiction? And in the same issue— —

Ms. KEZIOS. That would be a question— —

Mr. GEKAS. [continuing]. Based on contract law?

Ms. KEZIOS. You have got to find some law.

Mr. GEKAS.Common law?

Ms. KEZIOS. You have got to— —

Mr. GEKAS.Pardon me?

Ms. KEZIOS [continuing]. Find some law to take it up under. And that this patchwork quilt of State presale disclosure laws. You have got some post-sale laws; you have got a Federal—I mean that patchwork quilt is one of the biggest problems.

But, again, we are here to talk about the post-sale— —

Mr. GEKAS.I understand.

Ms. KEZIOS [continuing]. Problems, primarily.

Mr. GEKAS.I thank you for that.

Mr. Leddy, I am— —

Mr. ADLER. Could I just get my— —

Mr. GEKAS.Yes. Maybe I will come back to— —

Mr. ADLER. It is not quite as clear as that. The presale is terrific disclosure. But, as Doc Cohen suggested, that in all franchise systems, you need new stores. Some stores have to be closed because the population has moved away from you, demographics, competitive trends, and the presale really is a crucial document for your future. So if I look at a presale document of a franchisor, I can see how much litigation is going on. I can call all those franchisees. I can know the background and any perhaps sordid details, and the background of any of the officers. I can do a due diligence relatively simply by few other businesses that I could go out and buy, and find out what I am likely to encounter as I get into the relationship because I can look back 5, 10, 20 years in the history of that company. So I think it is very much intertwined.

Now, I enter into a contract. I have two choices; after I look at the presale, I can say, "aye" or "nay." If I don't like this franchise and I want to be franchising, I have thousands of other choices. I then enter into the contract; I can "aye" or "nay" there, and I do not have to do that.

One of the reasons—when you hear these stories I think are minuscule—this system works, and that is why it is so large.

Mr. GEKAS.Mr. Leddy, I just wanted to know as a matter of interest, wasn't there any kind of restrictive covenant or jurisdictional territorial limitation to prohibit Baskin-Robbins from locating a new store so close to yours in your original agreement?

Mr. LEDDY. No. The agreement is written to where they can basically put another store anywhere they want, except on the same premises. If they want to put a Baskin-Robbins store on every corner of every intersection, they can do that.

Mr. GEKAS.You knew that when you entered into the agreement?

Mr. LEDDY. It was in the agreement; yes. But the research that I had done—I did a lot of research—and I talked to other Baskin franchisees. I had a family that had several Baskin-Robbins franchises, and everybody was very happy. It was a—they had fun with the company; it was lucrative, and it was a good company. And, until recently—I would say probably the last 5 years—they have just become extremely greedy.

And what led us into this situation was Baskin-Robbins came up with a new concept for their business. And they were going to—and they came up against a situation to where they were going to have a very difficult time to introduce this new concept into an already saturated market.

So what they did was two-phased. They took selected existing stores and converted them to this new concept. Then, they picked some areas—mine was the first of that—to put a brand new store with that concept in there. And like I stated in my statement, I brought to the attention of the representative for the company, that you are going to have a very difficult problem here. There is cannibalization; there is going to be encroachment. You know, I am trying to sell my store. The reason my wife and I decided to sell our store was because we saw the direction of the company. And Mom always told me, "Look, if you don't like something, don't whine about it; just get out of it."

Well, I wasn't going to whine; I decided to get out, and let them run their company like they want. I don't want any part of it. But, then, they came along—little did I know—and they took an axe, and they just chopped our legs off.

Now, any person with any business sense, is not going to buy any store of any kind when they can see that—I had to disclose the fact to them that this is a Baskin-Robbins proposal. I have to, legally, and when that district manager of mine told me, "Don't disclose it." I told my wife—she told me that, and I said, "That is crazy; you can't do that." Your are sitting yourself up——

Mr. GEKAS.You would be liable.

Mr. LEDDY. I would be liable; yes.

Mr. GEKAS.The time of the Chair has expired.

Upon the advice and consultation of the gentleman from New York, we will recess for the purposes of a vote that is pending on the floor, and then return here, allowing everyone to get a Taco—[Laughter.]—or a burger or a whatever I can franchise——

Mr. COHEN. Or a cookie.

Mr. GEKAS. [continuing]. Until 12:30 p.m., when we will resume. So it is vote, then, lunch—[Laughter.]—until 12:30 p.m. We recess until 12:30 p.m.

We ask the panel to resume—yes, this panel shall resume at 12:30 p.m.

[Recess.]

Mr. GEKAS.The hour of 12:30 p.m. having arrived, the committee will come to order.

Although we must again await the presence of a second member, I will take this opportunity to continue the questioning by the Chair so that we will get the benefit of the presence of our witnesses, to whom we extend our gratitude, of course, for their patience and for having agreed to appear in the first place.

The gentleman from Tennessee, Mr. Bryant, is here. We may proceed on a formal basis. We yield to him for a round of questions, limited to—but not perfectly limited to—five minutes.

Mr. BRYANT. Thank you, Mr. Chairman.

As I said before, I want to keep an open mind on this issue, although I think maybe I start with something of a predisposition against the Federal Government becoming involved in private contracts.

But I did want to ask Mr. Cohen—and I think there is a point here that perhaps I could ask each one of you.

But, Mr. Cohen, why didn't you just open up a cookie store on your own? And do your own recipe, and sell cookies?

Mr. COHEN. Well, I asked myself that same question a number of times, and especially after I had a few of them opened and knew how to do it.

The answer is that somebody had already done all the homework for me and had already established a system. They had already done a trademark. They had already done logos, paper products, had a recipe, an established proven system that worked. And so I went with it because it was easier at the time.

Later on, when people said, "Why don't you just take their name down and when your lease and contract are up and become Doc's Cookies?" And the answer to that was, "I wouldn't be in the cookie business if they hadn't given me that start. I owe it to them."

And so the franchise fee that I pay is something that I think I should pay, because if not for them, I wouldn't be in the business.

And I would like to point something out. I would like to give you a sampling of some statistics that were done as a result of a survey by the Gallop Organization, because some testimony was out—that came out here earlier about franchisee satisfaction. And the Gallop Organization, as all of you know, has been around for many, many years and tends to get a very broad base of opinion that is representative of the entire franchising community, rather than one specific segment.

And they just did a survey in 1997, and that survey showed that 92 percent of franchisees consider themselves somewhat or very successful; 65 percent said they would purchase the same franchise again; 93 percent believe being associated with a franchise gives them an advantage—and that was one reason why I chose to go with a franchise to begin with, because I felt it gave me a tremendous advantage. Nearly three-fourths said that their expectations about franchising were met. Average gross annual income was over $91,000, and nearly one-fourth had gross incomes of over $100,000. And 88 percent would recommend franchising over opening non-franchised. And I would agree and put myself in that category, because if I had to do it all over again, even knowing what I know today about running a cookie store, I would still be part of franchise.

Mr. BRYANT. Okay. Let me ask Mr. Dunafon—am I saying that right? Dunafon?

Mr. DUNAFON. Yes; yes, sir; that is correct.

Mr. BRYANT. My Tennessee pronunciation.

Mr. DUNAFON. It all works. [Laughter.]

Mr. BRYANT. Obviously, you and Mr. Leddy are certainly franchisees that are not satisfied, and certainly you have—you present terrible situations that have occurred to you. And I don't doubt there are others out there that this has happened to.

You mentioned that you were able to go out in a co-op arrangement with other people and buy certain supplies cheaper.

Mr. DUNAFON. That is correct.

Mr. BRYANT. That is making more money, but wouldn't an argument be to that, that under the franchise agreement—something like Mr. Cohen alluded to—that other franchisees, you know, it is better for everybody to have that consistency, that same product, or——

Mr. DUNAFON. Sure. In addressing that, the products were exactly the same quality. They were approved—the vendors were approved by Taco Bell Corporate. The issue at stake—and Ray Kroc, who most people recognize as Mr. McDonald's, once wrote in a book that a franchisor should never be involved in distribution of products to their franchisees. If nothing else, it sets up an aura of untrust.

While a Taco Bell franchisee, for 4 years, I served on Taco Bell franchise—on the Franchisors Advisory Council. Two of those years, I was vice president of marketing for the franchisees. We attempted, in that term, as the board of—this manager board was called FRANMAC—and we attempted to get Taco Bell to allow us to at least work with them to get lower landed cost of our goods. They refused to disclose to us the cost of the goods that they negotiated by contract.

What they were doing was master contracting those goods as Taco Bell Corporate, then, selling them to PepsiCo Food Services at an additional markup, and then PepsiCo Food Services was selling it to us at their markup. So we were paying, if you will, a second-tier royalty for our cost of our goods that we were getting to run our restaurants.

When we were able to get the co-op on board, we had a true vendor relationship. And a co-op, by its nature, of course, is for the members.

Mr. BRYANT. Mr. Chairman, can I have unanimous consent to have two additional minutes?

Mr. GEKAS. Without objection, the gentleman is granted two additional minutes.

Mr. BRYANT. I wanted to ask, again, Mr. Dunafon, you and Mr. Leddy, specific questions on those points.

Would you anticipate—would you desire in any Federal legislation that might eventually come out of a hearing such as this, that it would include such specifics as being able to purchase from different people or are you limiting their right to limit you to purchase from them? Or, language that would put in a geographic location, a protection of territory-type issue? Would you expect Federal legislation to deal with those kinds of issues in a franchisor/franchisee agreement?

And I would like to have both of you answer, if I could.

Mr. DUNAFON. Myself, not specifically; no.

What I am concerned with in Federal legislation is a piece of legislation that establishes a fair standard of operation, where, if I, as a franchisee, am injured under my contract, I am not put in a position that I was put in, which was I had a contract that said "choice of California law." But in the Federal courts, that wasn't enough help. And, therefore, I was denied the major portion of my claim, which was my right of free association.

That is a pretty basic right, isn't it? To have a right of association?

And those are the kinds of things that I would see as what I would want envisioned in a piece of legislation. Something that sets a uniform standard that says, "Here are the basic guidelines."

As I stated before, both, you know, Ms. Goodman and Mr. Adler down here talk about their great relationships, and I am glad to hear that. I wish I hadn't had my relationship—[Laughter.]—turn negative. But I was raised with certain values, that what was right was right, and what was wrong was wrong. And when I questioned the wrong, I was run out of the system.

Mr. BRYANT. Let me, if I could, yield some time to Mr. Leddy and let you respond.

Mr. LEDDY. It is my opinion that not all franchisors are bad, and it is not those franchisors that I am concerned with. We have heard some testimony here today that the legislation that we want to adopt here isn't for those people. It is for the people that are taking advantage of other—of people like myself and these people behind me. We need some protection for us against those people.

Like Baskin-Robbins, as I told you before the break, hasn't always been like this. They haven't. It was a good company; it was a fun company. I met Mr. Robbins in Las Vegas during one of our conventions. He is a very nice man, and it was my understanding—of course, that was only rumor—that he didn't show up to the last convention because he wasn't happy with the direction of the company and what it was doing to the franchisees, so he didn't speak.

On the issue of placement of stores, I think in my case, if it had been—there are two issues there. You can place it in a proximity, or you have to look at the population density. I know of stores that are as close as the one that they put in to me that don't have a problem. But my problem happened to be population density. There wasn't the population density to support the two stores. I told them that; I gave them a map which I do have with me, and it shows the area. And on three sides of this store that they put are mountainous. There was no place to pull for customers, except for what I already had as an established market. I addressed that issue. They said that their experts said I was wrong, that they were going to go ahead with the plan. And I don't know if you noticed the charts there or not, but it was a drastic, drastic fall in my sales.

Mr. BRYANT. Thank you, Mr. Leddy.

Thank you, Mr. Chairman.

Mr. GEKAS.The time of the gentleman has expired.

We now yield to the gentleman from New York for the customary 5 minutes for a round of questioning.

Mr. NADLER. Thank you.

Let me ask, I think Mr. Adler.

Mr. ADLER. Nadler. [Laughter.]

Mr. NADLER. Well, I am glad to hear—I am glad to hear you are a liberal Democrat. That does my heart good.

Let me ask you, sir—[Laughter.]—you have heard the testimony of Mr. Leddy, Mr. Dunafon. Now, obviously, we don't want to restrict franchisors—we don't want to restrict the ability of the franchising system to grow and to prosper. We don't want to try to legislate the franchise agreements. We don't want to—I think Mr. Cohen said that it is essential for the franchisors, in order to protect the ability of the franchisees to prosper, as well as themselves to prosper, to be able to provide the proper marketing and standards and so forth. And, obviously, we don't want to do anything about—to restrict any of that.

On the other hand, you have heard some of the testimony of what happens with franchisees with franchisors who aren't perhaps the most caring about their rights and responsibilities.

And I would ask you, sir, don't you think we could have legislation that would be in the middle? That would grant some rights to franchisees or establish some basic standards that wouldn't do damage to the ability of franchisors to maintain standards?

For example, everybody else in the business world operates under the UCC. Everybody else has to obey the duty to—what is it?—the various duties that Congressman LaFalce mentioned, the duty to—what was it?—the duty of good faith and a few others.

Do you think it would harm anybody if we were to enact those duties into law? If we were to say you have to abide by some of the—not the UCC, but some basic business and ethical standards?

Mr. ADLER. A fair question, and one—remember, I am a franchisee, too, so I am able to cross back and forth.

I think there would be irrevocable damage, and it wouldn't seem so—first of all, if you do go to litigate on a contract, I can tell you the few times we have done it, the courts will lean over backwards to find for the franchisee any reason possible because they see, oftentimes, mistakenly—they see the little guy versus the big guy. And what is lost—what I made earlier in my comments—is that we need a strong system to protect the franchisees. I would say that even—I could find one or two franchisees who could give a speech, not unlike Mr. Leddy, with Moto, where we have tried to always do the right thing.

In one market, we went out of our way to give more territory. We were nice guys. Our franchisees complained. Eight years ago, we gave large territory so there wouldn't be a Moto nearby. The aftermath of that——

Mr. NADLER. There wouldn't be a right nearby?

Mr. ADLER. We gave large territory.

Mr. NADLER. Oh, okay.

Mr. ADLER. Because that is what a franchisee wanted. And a franchisee said to us, "Boy, if you put a store three miles away, you are really going to hurt our business."

Well, it turns out it is now—if we could only turn back the books. Our competitors came in and ringed our stores, and half of those franchisees have lost their business.

So, by being what we thought was a nice person, by not going by what we knew was right, has really put those stores in there. And if a store lost 5 percent in the short term of sales, or 8 percent in the long term, the history would be they would be very successful.

Another example—it all seems so benign when you get into it. One of the proposals is that all franchisees be treated evenly. Well, if we did that, we would be terrified. If you are a financial problem, and I gave you some help. And Mr. Bryant we don't want to help so much because he is not in his store; the store is not clean; he is not keeping up standards. Now we have got to defend ourselves. We know we are looking at a lawsuit, and this encourages the litigation. And so, you know what? We will do nothing.

It is my belief, and I just sound very harsh. I looked at that. If the package were enacted the way you talk about, if somebody took me through it. It all seemed very reasonable to me until I began to understand it and have practical experiences, I don't think we could survive as a franchisor anymore. We would go company short, because we could not maintain our standards, and we would not have an agreement to protect the system.

Mr. NADLER. Ms. Kezios, I would ask you for your comments on what Mr. Adler just said, and, in particular, with respect to perhaps the UCC and the duty of good faith and so forth.

Ms. KEZIOS. Well, if—I would like to know what—where is your empirical evidence on the irrevocable damage if we would enact a duty of good faith? I mean there are several States that have got duty of good faith in State laws, and you are probably already operating under those laws in some of those States, Mike.

You know, we are talking about standards of conduct. There is nothing in the package that was proposed, Coble-Conyers, that states that a franchisor can't enforce its system's standards. There is nothing in there that says that. As a matter of fact, it says you can get rid of under-performing franchisees, is what Mr. Adler's concern was.

A duty of good faith—a standard of duty of good faith would just require, in Mr. Leddy's case, that a franchisor would be a little more reasonable and maybe a little more fair before he thought about putting that other unit two miles from Mr. Leddy's store, because a duty of good faith implies that both parties have a right to expect the expected fruits of that contract. And Mr. Leddy bought that franchise expecting those rights.

Mr. NADLER. So——

Ms. KEZIOS. And the company did something down the road.

Now the company—our viewpoint is that a duty of good faith would do nothing more than cause franchisors to be more reasonable, more factual, and more fair in how they treat their franchisees.

Mr. GEKAS.We yield to the gentleman an additional 2 minutes.

Mr. NADLER. Thank you, sir.

Mr. ADLER. Can I respond to that?

Mr. NADLER. Go ahead.

Mr. ADLER. Again, it sounds reasonable except—first of all, any franchisor would be crazy to harm Mr. Leddy. What is going to happen is he won't be able to pay his bill.

Mr. NADLER. But they did.

Mr. ADLER. That is very subjective. And, remember, we are hearing one side. I will just give one fact—I don't know this case—but Moto does not give territories for malls. Why? Malls will pull from 10 to 15 miles. We give it for——

Mr. NADLER. Excuse me, let me interrupt you for—I hate to interrupt, but I do have only 2 minutes.

You are talking about—I mean it is one thing to sit here and say that a franchisor should be a win/win situation, and any franchisor would be ill-advised to do X, Y, or Z, and that may be. But people do things that they are ill-advised to do. And we have had enough complaints that people have done things which perhaps—which obviously you wouldn't do, and I commend you for that, obviously—and Mr. Cohen wouldn't do. But people do things that really injure other people. And we have heard of this, and it seems that to say that what we know is happening shouldn't happen because people should act rationally is not an answer, because people do not always act rationally.

Mr. ADLER. Yes, but I guess I am saying you are jumping—I don't know how to be diplomatic about this—you may be jumping to conclusions hearing only one side.

It may be very well, if I am a representative of a franchisor, I will say I can't let my competitor get into that mall. That means advertising is going to go for his brand and not my brand. I am saying, "Mr. Leddy, I am going to help you. The market value has declined $40,000." I can't guarantee your profit, and I don't know any franchisor that guarantees their profit. That would be a travesty.

So we all take our business risks out there and try to make the best calls we can. And that is awfully easy for somebody to say, "Well, I think your call is wrong." And the franchise system saying, "We have hired experts. We have done empirical data. We have done real estate studies. We are making the best call we can for all."

Mr. NADLER. Fine. But let me ask you the following, and this will be the last question——

Mr. ADLER. Sure.

Mr. NADLER [continuing]. Because my time is about to run out.

Every other business in this country operates under the UCC, has a duty of good faith. Why—in a myriad of different kinds of business arrangements, millions of different kinds of business arrangements—why are franchisors so different that they should not operate under some of the same laws that everybody else does?

Mr. ADLER. I am not a practicing lawyer, so probably Dennis will answer that a little bit more——

Mr. NADLER. Maybe Mr.——

Mr. ADLER. But let me give you a practical matter, as it is not normal contractual relationship. It is a partnership. I do not view—some will differ with this—franchisees as my customers. They are my partners. And it is——

Mr. NADLER. Yes, but partners operate under the UCC——

Mr. ADLER [continuing]. Like a family.

Mr. NADLER [continuing]. Under the UCC.

Mr. ADLER. What is that?

Mr. NADLER. Partners operate under the—partners are great until they have a split, and then they have a bitter litigation. [Laughter.]

Partners also operate under the UCC and under the normal commercial laws and under a duty of good faith.

Mr. ADLER. Well, I guess I am saying the current contract laws really work. The percentage of franchisees in litigation I am guessing are less than a fraction of 1 percent right now. So the cases, if you peel them back, a lot of the cases—the reality is FTC has only investigated 6 percent. I have no knowledge of that, but maybe the 94 percent didn't have substance behind them.

Mr. GEKAS. The time of the gentleman has expired.

This brings to a close the testimony of this distinguished panel. The written statements that you have submitted will be very helpful to us as we go down the path of analyzing this issue. And your verbal testimony is of great value.

We thank you for your patience and for your attendance.

You are gently dismissed. [Laughter.]

We invite the next panel to take their places at the witness table.

Dr. Timothy Bates is invited to join us, the distinguished professor of Labor and Urban Affairs at Wayne State University, in Detroit, Michigan. He was previously associated with the New School for Social Research where he was chair of the Urban Policy Analysis Graduate Program. Dr. Bates received his M.S. and PhD. in economics from the University of Wisconsin. He obtained his undergraduate degree from the University of Illinois in 1968. Dr. Bates has written extensively on urban and economic issues and on the impact of minority entrepreneurs.

Dennis Wieczorek is a partner at the Chicago offices of Rudnick and Wolfe where he heads the franchise and distribution group. His practice is concentrated on domestic and international franchising, licensing, antitrust, and distribution law for more than 20 years. He obtained his law degree from Duke University and an undergraduate degree magna cum laude from Washington University, in St. Louis, Missouri. Mr. Wieczorek has written and lectured extensively on the subject of franchising law. He is a member of the America Bar Association's Franchise Law Journal Editorial Board. In 1990, he was appointed to the Advisory Committee to the North American Securities Administrative Association Franchising Business Opportunities Committee.

Peter Singler, Jr., is with us. He is an attorney from Sebastopol, California. In addition to his law practice which primarily concentrates on business law, he is a director and major shareholder in his father's company which operates Round Table Pizza restaurant franchises. In his law practice, Mr. Singler represents the interests of franchisee clients in the food service and hospitality sectors, as well as the auto service, travel, healthcare, and financial service industries. He is a member of the American Franchisee Association's Board of Directors. Mr. Singler received his law degree from the University of Pennsylvania Law School and obtained his formal business education from the Wharton School.

The final panelist is Larry I. Tate, vice president of Franchising worldwide for Golden Corral Corporation. He is responsible for increasing franchisee's capital investment in Golden by more than $1 billion. Mr. Tate has more than 30 years of experience in franchising in the food service industry. He has experienced both sides of the franchisor/franchisee relationship. Before joining Golden in 1984, Mr. Tate was associated with Baskin-Robbins, Orange Julius International, Manpower, Inc., and Shakey's Pizza. Mr. Tate is a director of the International Franchise Association and is a member of the California Bar, American Bar Association, and the International Bar Association. He received his law degree from the University of Michigan.

As we had indicated to the other panel, your written statements will automatically, without objection, become a part of the record. We will allot 5 minutes for each of you to summarize your written statement.

And we will begin with Dr. Bates.

**STATEMENT OF TIMOTHY BATES, COLLEGE OF URBAN, LABOR AND METROPOLITAN AFFAIRS, WAYNE STATE UNIVERSITY, DETROIT, MI**

Mr. BATES. Well, thank you, Mr. Chairman.

I have been studying small business start-ups for the last 29 years. And over the last 11 years, I have had the opportunity to work with the U.S. Bureau of the Census to develop more sophisticated databases describing small businesses in this country.

In developing those databases, I have looked at a variety of issues, examined stereotypes, and the stereotypes that we have about small business often don't hold up under scrutiny. And one of those stereotypes that interests me is the notion that franchising is a safe bet. That has certainly been our conventional wisdom in the 1980's and 1990's.

In 1995, I undertook a study for the SBA Office of Advocacy whereby I tracked a very, very large representative sample of small business start-ups. These are nationwide representative data. Of these small business start-ups, 3.1 percent of them were franchises. For the start-ups of the years 1986 and 1987, they were tracked through the end of 1991, to measure the proportions of various types of firms that were still in operation.

Comparing the franchise start-ups nationwide to the independent business start-ups, those started without the benefit of a franchise or parent, what I found is that the failure rate, the disappearance rate, for the independent business start-ups over that period, 1987 through 1991, was 31.9 percent. Just about 32 percent of them had shut down.

Among the new franchisees, the closure rate was 38.1 percent, a higher closure rate nationwide for new franchisees than small businesses, generally, the opposite of stereotype.

Overall, looking not only at survival, but profitability as well, the picture was one that was detrimental to the stereotype. The franchise route to self-employment simply was associated, no matter how you carved up the data, with higher business failure rates and lower profits than the alternative route of simply starting an independent business.

Now this fascinated me. I hadn't expected that finding. I hadn't undertaken it with an agenda, but I had read studies over the years, with some amusement, such as the IFA study that came out in 1992 done by Arthur Anderson, claiming that about 97 percent of all franchise units opened nationwide within the past 5 years were still in operation, i.e., almost no failure whatsoever among franchises.

When I first came out with my findings, they received a large degree of attention and started some controversy. And I noted with some encouragement in 1996, that the president of the IFA actually stated, "It has never been precisely clear as to how many units have changed hands or ceased operating."

Well, in this quandary, the Census Bureau I believe has provided the clearest data—and I must say they have certainly scrutinized by findings. And the databases I am using are very sophisticated databases. They are based on a nationwide survey of 125,000 self-employed persons. And these 125,000 self-employed persons are sampled and stratified to indeed represent the U.S. small business community.

Looking at the 1986–1987 start-ups that I studied, my sample would have represented nearly 3 million business start-ups during those 2 years, and almost 100,000 of those were new franchisees.

Now the franchisees, interestingly, were larger young firms. On average, they were five times larger than the new independent business start-up. Average sales nearly half a million dollars for very young firms. Those are big new firms. Capitalization, on average, about three times higher for the new franchisees than the new independent start-ups.

Now the accumulated wisdom of scholars is that the larger, better capitalized firm has higher survival prospects than the smaller, less capitalized firm. The exact opposite typified franchise self employment.

Scanning the data to try to get a handle on why franchisees seemed to be so much less profitable and failed at a higher rate, I was immediately struck by the disproportionate concentration in retailing. Over 38 percent of the new franchisees were in retailing which was much higher than the 16 percent overall. And, indeed, in retailing, the problem was more pronounced than in franchising, in general. I might add that retailing includes new restaurant units.

Looking solely at the 1987 net income of young retail franchisees nationwide, average profit minus $15,877. For the young independent retailers, average profit $10,368. These are very young firms, and we don't expect much in the way of profit in the first year or two of operation, but a differential between the retailers who were franchisees and independents was remarkable.

Following them once again for 4 years, at the end of the 4-year period, 61.3 percent of the new retail franchisees were still in operation versus 73.1 percent of the independent retail start-ups.

Mr. GEKAS. Would the gentleman bring his statement to a close as quickly as he can?

Mr. BATES. Yes. Overall, the point, of course, is that the stereotype, which had been consistent with information released by the IFA, was just dramatically, shockingly inconsistent with the data that had been collected by the Census Bureau and compiled by myself, leading me to strongly conclude that the conventional wisdom that franchising is a safe bet for start-ups is simply wrong.

[The prepared statement of Mr. Bates follows:]

PREPARED STATEMENT OF TIMOTHY BATES, COLLEGE OF URBAN, LABOR AND METROPOLITAN AFFAIRS, WAYNE STATE UNIVERSITY, DETROIT, MI

FINDINGS

Persons entering self employment by becoming franchisees commonly believe that their chances of surviving the early turbulent years of small business operation are improved by their decision to align with a franchisor parent company. The franchise is a safe bet, according to conventional wisdom. It is time to reconsider this wisdom.

My study—sponsored by the Office of Advocacy of the U.S. Small Business Adminstration—tracked survival patterns among franchise and nonfranchise small firms started in 1986 and 1987. A large, representative sample of these young firms was drawn from the U.S. Bureau of the Census small business data: all of these firms were surveyed in late 1991 to determine firm survival rates. By late 1991, 38.1 percent of the young franchise firms had gone out of business—shut down; the failure rate for the independent business startups was a lower 31.9 percent.

Although the franchise operations were larger scale, better capitalized young firms, the independent business startups were found to be more profitable and their survival prospects were better than those of franchises. *In short, the franchise route to self employment is associated with higher business failure rates and lower profits than independent business ownership.*

Owners making their initial entry into self-employment by purchasing an existing franchise operation from a previous owner—the most widespread route to entry in retailing—are particularly at risk. The ongoing franchise units that are available for purchase appear to be disproportionately prone to going out of business. My study tracked a large group of ongoing franchisee operations that were bought by new owners in 1986 and 1987: only 52.4 percent were still operating in 1991 with the owner of record present in 1987. The ongoing franchisees lag badly behind their independent small-business owner cohorts when it comes to keeping their firms in operation.

BACKGROUND

For four decades, the International Franchise Association (IFA) has been promoting the idea that small businesses in general have much higher rates of discontinuance than franchised small firms. A book by Atkinson (1968) presented evidence that most small retail firms close down within five years, while franchises were estimated to discontinue operations at an annual rate of 1.6 percent. A report of the U.S. Senate Select Committee on Small Business criticized the methodology used by Atkinson, concluding that "the book *Franchising: Odds-On Favorite* by J.F. Atkinson, published by the International Franchise Association, makes erroneous comparisons with overall retail trade failure rates" (p. 98, 1971). The prestigious Conference Board sifted through the various studies and conflicting claims about franchisee viability and concluded that there was no solid evidence that franchisees had either a better or poorer chance for business survival than similarly qualified independent entrepreneurs (1971).

Similar claims of low franchise discontinuance rates have commonly been received with skepticism reminiscent of the Atkinson study. Figures cited by Ashman (1988) indicated that 92 percent of franchises are still in business at the end of five years, versus only 23 percent of the independent firms. Ashman's results, which cite the "U.S. Department of Commerce" as their source, typify business discontinuance rate figures that have been used in industry promotional literature. In fact, the U.S. Department of Commerce has, until recently, conducted annual surveys of franchisors and published the results in biennial reports, *Franchising in the Economy*. According to the staff of the U.S. House of Representatives Committee on Small Business, a comprehensive review of the *Franchising in the Economy* reports "fails to show any figures providing comparable failure or success rates for franchises or franchisees. On the contrary, the reports note specifically that the number of failures is unknown" (*Franchising in the Economy*, 1988), cited in Hearings before the Committee on Small Business (1992, p. 144).

More recent research sponsored by the IFA claims that 96.9 percent of the franchised units opened nationwide within the past five years were still in operation (Arthur Anderson and Co., 1992). Significantly, this survival rate information was compiled by surveying franchisors—the corporations that sell franchises—rather than the actual franchisee owners of the businesses whose survival is at issue. Castrogiovanni, Justis, and Julian observe that "individual franchisors may be reluctant to 'air their dirty laundry' by reporting excessive failure rates . . . it is in the best interests of the franchise sector as a whole to convey the appearance that franchising is a relatively safe form of business ownership" (1993, p. 106).

Knowledgeable scholars who study franchising issues routinely express concern about the reliability of failure rate statistics publicized by franchisors. Lafontaine, for example, states "one of the major selling points of franchising to franchisees over the years has been the statistics vehiculated by the trade press on the very low failure rates of franchised businesses compared to independent operations. These statistics never had real scientific basis" (p. 39, 1995).

In the course of writing his recent doctoral dissertation examining several franchises in depth, Birkeland noted that many of his subject franchisees were disappearing. For example, among King Cleaners franchisees, turnover in one 12 month period was 35.1 percent: 29.7 percent discontinued outright and 5.4 percent sold their franchises to new owners (Birkeland, 1995). Discontinuance rates of franchisor parent companies were recently scrutinized by Shane, who identified all franchisor parent companies nationwide that first began selling franchises in 1983. By 1993, only 24.6 percent of these franchisors were still operating (Shane, 1996).

Studies of small business formations utilizing U.S. Census Bureau data on startups occurring during the 1984–1987 period have contradicted the IFA's claims of low franchise failure rates. A sample of 20,554 young firms drawn from the U.S. Bureau of the Census Characteristics of Business Owners (CBO) data base was examined by Bates (1995a, 1995b), and all of these firms were surveyed in late 1991 to determine survival rates. By late 1991, 34.7 percent of the franchisees and 28.0 percent of the nonfranchised young firms active in 1987 had discontinued operations.

Noting the "heated debate" surrounding the issue of franchise survival, IFA president Cherkasky conceded recently that "it has never been precisely clear as to bow many units have changed hands or ceased operating" (International Franchise Association Educational Foundation, 1996, p.1).

ANALYSIS OF SMALL FIRMS ENTERING FRANCHISING

My study analyzed firms in the Census Bureau's Characteristics of Business Owners (CBO) data base that were formed over the 1986–1987 period and the unit of analysis is firms, not establishments. Thus, the universe of firms covered in this section is 2,621,810 young small businesses, 82,202 of which are small business franchisees (franchisees were 3.1 percent of the 1986, 1987 small business startups that were operating in 1987) (Bates, 1996).

Table one data indicate that franchisees are generally better endowed with traits linked to survival than nonfranchised young firms. In terms of mean 1987 sales revenues, the young, franchisees report $440,391, over five times larger than the corresponding figure of $86,489 reported by the independent businesses (table one). Capitalization at startup is similarly much greater (mean value = $94,886) for the proprietorship, partnership, and S-corporation franchisee firms, more than three times greater than the nonfranchised firm capitalization of $29,319. Despite the obvious strengths of the young franchisee firms summarized in table one, they are dramatically less profitable than independent firms of the same age, and they exhibit a lower survival rate—61.9 percent (versus 68.1 percent for nonfranchised firms)—over the 1987-late 1991 time period. The differences in profitability are particularly dramatic: the average young franchisee reported negative profits in 1987, while the cohort independent small firm reported a profit of $15,511. Despite the advantages of being larger scale, better capitalized young firms, the franchises are dramatically less profitable and their survival prospects are worse than those of independent business startups.

Saturation in retailing niches (including restaurants) has been suggested as a possible cause of laggard franchise performance (Bates, 1995a). Extracting retail firms from table one, the franchises certainly lag behind the overall franchise population, as well as independent retail firms:

| | Young retail franchisees only | Young retail independents only |
|---|---|---|
| 1987 net income (mean) | –$15,877 | $10,368 |
| % of firms still operating in late 1991 | 61.3% | 73.1% |

The retail trait for young franchisees, however, may be highly correlated to another factor tbat is responsible for their laggard performance. Careful examination of the data base reveals one peculiarity of tbe retail franchisee group. They are much more likely to be entered by purchasing an ongoing operation from a previous owner (as opposed to starting a firm de novo): 53.5 percent of the young retail franchisee firms described in table one were ongoing when the present owner entered, versus 29.2 percent of the independent young retailers and 29.3 percent of nonretail young franchisees. Transfers of ownersbip among franchised units, according to a recent International Franchise Association Educational Foundation study, often arise in troubled situations. "In many cases, a franchised unit is not renewed or canceled and then subsequently is transferred" (p. 10, 1996). This transfer of ownership might place the unit directly in the hands of a new franchisee. Alternatively, ownership may revert to the franchisor, and the unit may be subsequently sold to a new franchisee owner.

There are two ways for the owner of a young franchisee firm to exit from the firm, and only one has been considered so far. The firm can either be closed down, or it can be sold to a new owner. Some of the franchisees operating in 1987 had changed ownership via such sales: 2.6 percent of the new firms and 15.2 percent of the ongoing operations that were still in operation in late 1991 had changed ownership. Among the ongoing, franchisee firms, only 52.4 percent were operating in late 1991 with the same owner (or owners) present in 1987: nearly half of the original owners were gone by 1991. Many owners of ongoing firms exit by selling the firm to a new owner, who keeps the business in operation. Since ongoing firms (i.e. those purchased from a previous owner) are most common in retailing, it follows that the larger retail franchisees are the ones most prone to ownership turnover. Table two tracks ownership turnover and firm closure patterns. On the issue of the ongoing characteristic being associated with franchisee discontinuance, table two offers insights. Among the firms active in 1987 that had been purchased from a previous owner, 32.4 percent of the franchisees and 18.2 percent of the independents had closed down their operations by late 1991. In other words, the ongoing franchisees were 78.0 percent more likely than the independents to close down (.182 x 1.78 = .324). The corresponding discontinuance rate differential for the new franchisees and independents was 20.8 percent. The ongoing franchisees have significantly higher sales, capitalization, more employees, and their owners are more likely to be college graduates, relative to the ongoing independent young firms. Despite their larger size and greater investments of owner financial and human capital, the ongoing franchisees lag badly behind their independent cohorts when it comes to keeping their firms in operation. This suggests the following hypothesis: *entering self-employment by purchasing an ongoing franchise operation is riskier than alternative routes to small business ownership*. Econometric analyses support this conclusion (Bates, 1998).

## SUMMARY AND IMPLICATIONS

Findings of my research indicate that new and small franchisees are more likely to discontinue operations than independent startups, and this holds true when firm and owner traits are controlled for statistically. One clear-cut finding was that franchisees starting by purchasing the firm from a previous owner were riskier than franchisees starting from scratch. A person entering self-employment by purchasing an ongoing franchise risks acquiring a firm that is more likely than a de novo startup to go out of business within the next few years.

Potential entrepreneurs drawn to franchising are often attracted by industry promotional material asserting that survival rates are high among franchised firms. Yet *the information needed by potential franchisees to make informed choices about risks of failure in franchise versus independent business startups is fragmentary and misleading*. What is needed? *First*, units owned by franchisors should be netted out, and descriptive statistics should portray the record of franchisee operations only. *Second*, information on franchisee startups should be disaggregated from data describing the established firms in the franchisee population. Cross-sectional information describing young and old operations alike runs the risk of generating survival rate statistics that overstate firm closure rates among the older firms, while understating the incidence of closure among recent entrants. *Third*, establishment data is much less useful than firm data when it comes to identifying new franchisee operation performance. The multi-unit franchisee opening up another establishment may enjoy low risk of unit closure due to its substantial experience functioning in the applicable industry niche (Bates, 1998). A newcomer entering the industry cannot assume that this low risk of closure has applicability to the startup lacking such industry-specific experience. The potential franchisee needs to know how startup *firms* have performed, and data describing new *establishment* performance cannot provide this information. *Fourth*, studies of franchisee survival would convey more useful information if they were based upon data that were somehow representative of the franchisee universe. The recent IFA-sponsored study of discontinuance among franchise units owned by 444 franchise systems typifies this problem (International Franchise Association Educational Association, 1996). This study 1) fails to delineate franchisor-owned units from franchisee units, 2) mixes together young and old franchise units, 3) reports establishment, not firm data, and 4) does not explain how the 444 franchise systems studied fit into the broader universe of franchising in the United States. The potential franchisee who relied upon statistics such as these to judge the relative risk of firm failure in franchising, as opposed to independent business formation, is simply not relying upon useful information.

Table one: CBO Firms Operating in 1987: A Comparison of Firm Traits for Franchisee and Independent Business Startups (Firms formed from 1986–1987 Only).

| | Franchises | Nonfranchised firms |
|---|---|---|
| *A. Firms in all industries* | | |
| 1987 sales (mean) | $440,391 | $86,489* |
| 1987 net income (mean) | $–4,501 | $15,511* |
| Total financial capitalization at startup (mean) | $94,886 | $29,319* |
| % of firms in retailing | 38.6% | 16.5%* |
| % of firms still operating in late 1991 | 61.9% | 68.1%* |
| *B. Firms in retailing only* | | |
| 1987 sales (mean) | $911,522 | $130,371* |
| 1987 net income (mean) | –$15,877 | $10,368* |
| Total financial capitalization at startup (mean) | $146,139 | $45,966* |
| % of firms still operating in late 199 | 161.3% | 73.1%* |

*Trait differences between the above groups are statistically significant at the .05 significance level.
Source: CBO database.

Table two: Late 1991 Status of Young Firms that were Operating in 1987 (1986 and 1987 firm startups only).

| | All Franchisees | All Independent Firms |
|---|---|---|
| *A. Young Firms Purchased from Previous Owner (Ongoing Firms)* | | |
| 1. Operating, same ownership52.4% | 68.1% | |
| 2. Operating, new ownership | 15.2% | 13.7% |
| 3. Discontinued by 1991 | 32.4% | 18.2% |
| *B. All Young Firms* | | |
| 1. Operating, same ownership | 54.2% | 62.4% |
| 2. Operating, new ownership | 7.7% | 5.7% |
| 3. Discontinued by 1991 | 38.1% | 31.9% |
| *C. Young Firms Started as Births* | | |
| 1. Operating, same ownership | 56.1% | 61.5% |
| 2. Operating, new ownership | 2.6% | 4.3% |
| 3. Discontinued by 1991 | 41.3% | 34.2% |

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Mr. GEKAS. We thank you, Dr. Bates.

We turn to Mr. Wieczorek.

## STATEMENT OF DENNIS E. WIECZOREK, ESQUIRE, PARTNER, RUDNICK & WOLFE, CHICAGO, IL

Mr. WIECZOREK. Thank you, Mr. Chairman.

You have heard earlier that it is a misnomer to call franchising an industry. It is rather a business strategy that allows companies in over 70 industries to get products and services to consumers through franchise outlets.

My law practice is reflective of the diverse industries that utilize franchising as a method of——

Mr. GEKAS. Is your microphone on?

Mr. WIECZOREK. Now it is.

Mr. GEKAS. Now it is.

Mr. WIECZOREK. We represent franchisors in numerous industries, ranging in size from Fortune 100 companies with thousands of units to start up companies with 1 or 2 locations. Even within industries, for example, fast food, or sub-parts of those industries, hamburgers or pizza, there are major variations in how these companies do business and in the types of contracts they use. I see this everyday in my practice.

What all franchisors have in common is an absolute focus on creating a uniform brand image and a customer perception that quality products and services are available at locations identified by the brand. This is what franchisors have to sell. They sell intellectual property—the brand—and they sell system standards, a uniform method of presentation.

Any failure to follow system standards means a degradation of the brand. That injury to the brand injures all of the parties in a franchise relationship, not only the franchisor, but more significantly the franchisees who are on the ground dealing with consumers every day.

Attempts to legislate the terms of franchise relationships—that is to write the terms of franchise agreements—will only substitute the judgments of legislators and, ultimately, judges and juries in an already overcrowded court system for the business judgments of the parties directly involved in the relationship. Legislatures throughout the United States, and Congress, have recognized the fallacy of intruding in the business relationships between franchisors and franchisee.

On the Federal level, since the late-1970's, proponents of franchise legislation are batting 0 for 10. Ten bills were introduced, and none of them have gone anywhere. In the States, since 1992, proponents of franchise legislation are batting 0 for 30. Thirty States have considered and rejected bills. This is for a simple reason; no one wants it, not franchisees, not franchisors.

Franchisors are now subject to extensive regulation. While some States have enacted relationship laws, this regulation, both at the State and Federal level, largely relates to presale disclosure. Franchisors must disclose substantial amounts of information, including potentially negative information about litigation, bankruptcy, turnover statistics, and adverse financial data. These disclosure laws have been continuously updated and completely overhauled in 1993. And, actually, as we speak, the Federal Trade Commission is now making additional changes to the disclosure requirements. Franchisors have lived with these laws for 20 years, support them, and any improvements that are made in the coming years.

These laws, which allow prospective franchisees to make informed investment decisions, are far different from relationship legislation. The terms of the relationship are best left to the parties in their contracts and their day-to-day communications and dealings with each other as business people. These contracts vary widely from industry and within industries. Through the disclosure document, prospective franchisees can make their choices and evaluate which concepts are suitable for their needs and experience.

The major defect with franchise relationship legislation is the inducement that is created to litigate. Prior bills that have been introduced in Congress create scores of new Federal causes of action, with no minimum amount in controversy. Such legislation could stop franchising in its tracks, and at the very least, will create significant disincentives to the growth of franchising.

Franchise systems made up of local entrepreneurs compete vigorously with vertically integrated retail chains. Legislation along the lines of prior proposals cuts off these opportunities because franchisors simply cannot do business with such a high level of government intrusion.

Among others, women and minorities who are integral to franchisor expansion plans will no longer be able to take steps to become entrepreneurs.

I want to mention that Congressman Coble said earlier that he considered—actually a client of mine—Krispy Kreme Doughnut Company an excellent company. Krispy Kreme has told me that if legislation along the lines of what we have heard about and seen in prior years is passed, that they would cease franchising immediately.

Who benefits from franchise relationship legislation? Not franchisors, who cannot protect the brand and uniform image; certainly not franchisees who will have to live with substandard operators, and the adverse effect this will have on consumers.

So who will benefit? Of course it will be the lawyers like me and other franchise attorneys around the United States, and trial lawyers who will recognize new business opportunities available in the fertile field of franchise litigation.

Thank you, Mr. Chairman, for the opportunity to speak.
[The prepared statement of Mr. Wieczorek follows:]

PREPARED STATEMENT OF DENNIS E. WIECZOREK, ESQUIRE, PARTNER, RUDNICK & WOLFE, CHICAGO, IL

I am pleased to have the opportunity to appear before the Subcommittee on Commercial and Administrative Law of the Judiciary Committee of the U.S. House of Representatives.

I am a partner with the law firm of Rudnick & Wolfe in Chicago, with additional offices in Dallas, Tampa and Washington, D.C. Rudnick & Wolfe has what we believe is the largest franchise law practice in the US and probably in the world. Close to 50 out of Rudnick & Wolfe's 340 lawyers concentrate in franchise law. Along with 10 of my partners at Rudnick & Wolfe, I am listed in the International Who's Who of Franchise Lawyers. I have practiced as a franchise lawyer for 22 years and I have attached a biography and list of publications and speeches.

Our firm represents more than 400 franchisors and licensors and is general counsel to the International Franchise Association. Our clientele ranges in size from the largest franchisors in the world to development stage companies that may have only 1 or 2 units. I believe that the wide range in the size of our clients and the scores of industries they represent is a good sample of franchising as a whole.

FRANCHISING IS A BUSINESS STRATEGY IMPLEMENTED IN NUMEROUS INDUSTRIES

It is inappropriate to call franchising an "industry." It is a business strategy or concept whereby a franchisor can expand its brand with the efforts of its franchisees. Over 60 industries have used franchising as a strategy for expansion. These industries come in all shapes and sizes—from the multimillion dollar investment for a hotel franchise to the $5,000–10,000 investment for an at-home travel business franchise. Of necessity, the franchise programs for these disparate types of opportunities are shaped and formed based on the unique needs of each industry. In addition within each industry that uses franchising as a method of distribution, there are significant variations between companies in the way they do business and in the documentation of the franchisor-franchisee relationship. Finally, the type of franchisee and the size of his/her investment will make a vast difference in the structure of the franchise relationship.

For example, a small, start-up franchisor may be more willing to negotiate terms with prospective franchisees in order to be competitive with established franchisors. But even a large franchisor may be willing, and in some cases compelled, to be flexible if the franchisee is experienced and well-capitalized. As a lawyer, I have been involved in negotiations with franchisees on behalf of large and small franchisors and I have drafted franchise agreements that range in length from 10 pages to 100 pages. In some cases, the franchisee across the table from me was larger than my franchisor client. You cannot use a cookie-cutter approach when it comes to structuring a franchise program, even if the programs being structured are for 2 different franchisors that compete with each other in the same industry.

INDUSTRY-SPECIFIC LEGISLATION IS INAPPROPRIATE FOR FRANCHISING

Since franchising companies represent a plethora of industries, any attempt to legislate the terms of the franchisor-franchisee relationship fails to account for the vast differences in the programs and systems used by franchisors. Some have referred to other federal legislation, such as the Petroleum Marketing Practices Act, 15 U.S.C. § 2801 ("PMPA"), and the Automobile Dealer-Day-in-Court Act, 15 U.S.C. § 1221 ("ADDCA"), as supporting the argument that legislation is appropriate for relationships that involve the distribution of products or services and the licensing of brand names. In my view, such existing laws do not provide any principled basis for the creation of general franchise relationship legislation.

First, each of these statutes deals with a single industry—in the case of the PMPA, petroleum dealers and their suppliers; in the case of the ADDCA, automobile dealers and their suppliers. Each of the laws was drafted to deal with problems and concerns arising in a specific industry. Also, in each industry, suppliers were few in number and there were significant barriers to the entry of dynamic new rivals with innovative distribution programs and concepts. Contrast this with the fast food industry, where there are hundreds of competitors and new entrants appearing on a regular basis. Even within the fast food industry, there are sub-markets (e.g., hamburgers, chicken, Mexican) and sub-sub-markets (e.g., sit-down versus carry-out versus delivery pizza and combinations of same).

There are also unique issues relevant to each of these existing laws that starkly contrast with prior versions of proposed general franchise legislation. The PMPA is a very narrow law focused only on restricting the grounds for terminating or refusing to renew a gasoline dealer. In addition, the PMPA is preemptive; it overrides all state laws that deal with the same issues. The general franchise legislation that has been proposed in prior years is not preemptive and covers a broad range of subject matter. The ADDCA is likewise narrowly drawn and has been little used in recent years. By my count, there have been only an average of 2 reported ADDCA opinions per year over the last 10 years. Apparently, state automobile dealer laws have largely supplanted ADDCA as the remedy of choice for dealers.

## THE CURRENT STATE OF FRANCHISE REGULATION

The burdens of regulation are now quite heavy for franchisors. Extensive pre-sale disclosure is required by the Trade Regulation Rule on Franchising issued and administered by the Federal Trade Commission. In addition, 15 states require pre-sale disclosure, 12 of which mandate administrative review and approval before a franchisor can do business in the state. Also, 18 states have enacted laws that regulate the relationship between franchisor and franchisee. This patchwork quilt of regulation has created significant compliance costs for franchisors. These laws have forced franchisors to retain lawyers like me to help navigate the treacherous shoals of federal and state franchise regulation.

On the disclosure front, a franchisor must prepare what is known as a Uniform Franchise Offering Circular (or "UFOC"), which contains extensive information about the franchisor, the franchise program and the franchise agreement. If the franchisor has any negative information to report on things like litigation, bankruptcy, unit turnover and financial performance, it must do so for the world to see. Every prospective franchisee is given this information, and has at least 2 weeks (and in practice usually several months) to review it. The prospect can compare the disclosure documents of several franchisors, side by side, and make an assessment of the pluses and minuses of each franchise.

The UFOC format was completely overhauled 6 years ago and the FTC is now considering additional changes to modernize and update the UFOC. This disclosure improvement process has been carried out on a cooperative basis, involving representatives of government, franchisors and franchisees. As a member and current Chair of the Advisory Committee to the North American Securities Administrators Association Franchise Project Group, I have been intimately involved in the disclosure modernization process, and have seen the work that has been done to ensure that prospective franchisees receive an extraordinary quantity of information to evaluate a franchise opportunity. For example, a franchisor that has been involved in extensive litigation with its franchisees must reveal this, and a prospect should be careful to evaluate this fact in assessing the attractiveness of a franchise offering.

In my view, the disclosure process is here to stay and will continue to be improved and updated. If this Subcommittee or others desire to make additional disclosure improvements, I have no doubt that they will be supported by the franchising community.

Additional legislation or regulation mandating new or improved franchise disclosure is far different from legislation affecting the relationship between a franchisor and its existing franchisees. In fact, legislation altering or negating the terms of existing contracts would be problematic as a constitutional matter. Thus, any legislation that modifies contractual terms can be prospective only and therefore would be applicable only to future franchisees. In my view, it is appropriate to ensure that those future franchisees make fully informed investment decisions as a result of a fully realized disclosure process. This is a more practical and achievable goal than to create relationship legislation that puts franchisors, from numerous disparate industries and in various stages of development, in contractual straitjackets, exposes then to undefined liabilities and subjects them, and the already overcrowded federal courts, to the burdens of a new wave of litigation. In addition, a potentially more damaging effect of relationship legislation is the impediments it creates to the enforcement of system standards. If a franchisor cannot enforce quality controls, the brand is damaged at the consumer level and the entire franchise system, including franchisees, will suffer.

## IMPACT ISSUES—HOW CLOSE IS TOO CLOSE?

Some of the prior bills proposing to create franchise relationship legislation have included provisions prohibiting franchisors from "encroaching" on franchisees. Simply stated, if a new outlet is in "unreasonable proximity" to an existing outlet, the franchisor has violated the law.

How close is too close? In downtown Washington, D.C., you may be able to put 2 outlets within a few blocks of each other and neither would have an impact on the other. In an enclosed shopping mall, you may have one outlet in a food court and another one 100 yards away on an out lot of the shopping mall and neither would have an impact on the other. On the other hand, in a rural area, placing 2 outlets within 10–20 miles of each other may be too close. If you expand these examples to the scores of industries represented by franchising, the complexities and difficulties of assessing impact grow exponentially. How close can you place 2 hotel franchises or 2 real estate brokerage franchises or 2 sales training franchises? How large or small can you make the territories for a carpet cleaning franchise or a lawn care franchise or an insurance sales franchise?

The State of Iowa enacted a franchise relationship law in 1992 that contained a detailed encroachment provision (the only state franchise relationship law with a comprehensive encroachment section). That provision proved to be so difficult to interpret and apply that it was completely overhauled by the Iowa legislature only 3 years later in 1995. Every year since then there have been strong efforts to modify the provision yet again.

Legislative efforts to regulate the siting of new outlets are unworkable. However, individual franchisors have made great strides in recent years in formulating and implementing impact policies. Those policies take into account the competitive aspects of the relevant industry and, more importantly, the unique features of each franchise program and even variations within the program. For example, a hamburger chain's impact policy must not only deal with the impact of a new standard unit on an existing location, but also assess the different competitive effects of a unit in a mall food court or a co-branded unit operating within a gas station/convenience store or an express unit located in a discount department store. Those judgments, and impact relief if warranted, are best made within a single franchise system.

SOURCING ISSUES AND CUSTOMER EXPECTATIONS

Federal and state antitrust laws provide a panoply of remedies to franchisees aggrieved by illegal sourcing restrictions imposed by franchisors. However, prior proposed franchise relationship bills have sought to go far beyond the scope of the antitrust laws.

Why do franchisors impose restrictions on the sources available to franchisees for the purchase of products and supplies? The primary motivation is creating a uniform brand image and satisfying customer expectations of franchise chain-wide quality and consistency. In addition, many franchisors enter into arrangements with suppliers to achieve economies of scale, to provide one-stop shopping to franchisees and to ensure that product specifications are met by a national or regional supplier. In other cases, sourcing restrictions may be critical to guarding trade secrets or other proprietary information.

Some franchisors do sell products to franchisees and profit from same. In some cases, a franchisor charges little or no royalties to its franchisees; its sole or primary income stream is from product sales to franchisees. Of course, the other side of the coin is that some franchisors sell nothing to franchisees, their sole source of revenue being royalties. These matters are fully disclosed in the UFOC and prospective franchisees can weigh this factor in assessing the overall franchise opportunity. If there is an antitrust violation arising from a franchisor sourcing program, franchisees have viable statutory bases for obtaining redress.

FRANCHISE TRANSFERS

Another recurring feature of prior franchise relationship legislative proposals has been the inclusion of detailed provisions on franchise transfers. These provisions essentially allow franchisees to sell all or part of their franchise rights to third parties, sometimes without allowing the franchisor any evaluative role in the process.

First, a franchisor should have the right to approve a transfer of a franchise; it would be unprecedented to require a franchisor to deal with a "stranger" to its contract. In addition, prior proposals provide no guaranties that the franchisor's standards of quality would be adhered to during the transition period of a successor franchise. Also, free transfer rights would allow competitive chains to buy interests in franchisees and obtain access to trade secrets and proprietary information.

The need for such legislative proposals is surprising since most franchise agreements appear to contain an undertaking by the franchisor not to unreasonably withhold consent to a transfer. In my experience, a franchisee that is interested in selling his or her franchise is helped by the franchisor in searching for buyers for the franchise. Once a franchisor learns that a franchisee wants to leave the system, it is in the franchisor's best interests (both for its own self-interest and the brand image expected by customers) to facilitate the process, find a qualified replacement and oversee a smooth transition process. The need for legislation in this area appears to be unwarranted, particularly in light of the fact that these issues have rarely been the subject of litigation in the 1990's.

### PRIVATE ENFORCEMENT OF FRANCHISE REGULATION

One of the elements consistently included in the general franchise legislation that has been proposed in prior years is that franchisees should have a private right of action to enforce any of the elements of such legislation. While on its face this appears to be an unremarkable proposition, the implications for enforcement of an extensive, detailed regulatory scheme are complex and difficult. Such proposed general franchise legislation usually states that a violation of the FTC Trade Regulation Rule on Franchising is actionable by a private party.

First, the FTC administers numerous Trade Regulation Rules and I am not aware of any that are enforceable by private parties. Even Rules intended to protect "true" consumers, who receive none of the disclosures and have fewer resources than prospective franchisees, do not allow for private actions. Also, the FTC's interest in redressing "public" injury and in achieving quick administrative relief could well be at odds with the interests of private parties and their lawyers. Private enforcement will often take the form of a counterclaim filed by a franchisee in litigation where the franchisor is seeking to collect money or stop a violation of quality control standards. Finally, the FTC Franchising Rule is comprised of a set of complex regulations, supplemented by Interpretive Guides, a Statement of Basis and Purpose and Interpretive Opinions. Giving a right to enforce these hundreds of pages of rules will wreak havoc with the FTC's enforcement mission and well overwhelm the federal courts with claims revolving around minor and technical issues. For example, is it appropriate to burden the courts with claims that a franchisee received a UFOC only 9 business days before he/she bought a franchise, rather than the mandated 10 business days. This is one of hundreds, even thousands, of technical requirements which could turn into a "federal case." Further, such private actions in federal court would potentially conflict with interpretations of state disclosure law which, unless specifically preempted by federal law, would create additional confusion and litigation burdens.

### GOOD FAITH AND THE RISKS OF LACK OF CERTAINTY

It has been suggested in prior proposed general franchise legislation that parties to franchise agreements be required to deal with each other in "good faith." As a general precept, such a requirement is consistent with the common law of almost every state, where courts have stated that good faith inheres in every commercial contract. However, the proposed legislation goes much farther than the generally accepted definition of good faith. The courts have treated the duty of good faith as a "gap-filler"; i.e., if a contract does not cover a specific issue or it fails to fully explicate a particular term, then the courts will use the duty of good faith to fill the gap to discern the parties' intentions. Under the judicial interpretation, the duty of good faith cannot be used to alter the express terms of contracts.

Prior proposed general franchise legislation has treated good faith as a means of subverting and avoiding contractual obligations and undertakings. These proposals have broadened the duty of good faith to go far beyond the common law interpretations, and even beyond the Uniform Commercial Code. In the end, if this broadened interpretation is enacted, the terms of franchise agreements can be ignored and the concept of contract finality will be a nullity. Every dispute will be left to a judge or jury to determine whether a party acted "in good faith." Obviously, there will be little incentive for parties to reach accommodations to resolve a dispute, when it may be more worthwhile to "roll the dice" with litigation and argue that a particular act or practice violated a vague and amorphous duty of good faith.

### WHY TALK WHEN WE CAN LITIGATE?

There can be little doubt that prior proposed franchise relationship legislation created numerous opportunities for trial lawyers to find profitable employment fomenting litigation within franchise systems. In some of these prior proposals, there were scores of new causes of action that could be filed in the already overcrowded federal courts, without even any minimal amount in controversy. These proposals, with available awards of attorneys' fees and costs, create every incentive for the parties to litigate rather than work out the problem on a face-to-face basis.

At the end of the day, oppressive legislative restrictions on the operation of franchise relationships, and the litigation that is sure to follow, will simply stop franchising in its tracks. Under legislation similar to what has been proposed, how can a franchisor compete with a vertically integrated competitor who operates all of its own retail outlets, a competitor that has complete and total control over its stores? Why should a company make franchises available to franchisees when a legislative regime risks the viability of its brand image and existing customer satisfaction? What will happen to entrepreneurial opportunities for women and minorities who have become an integral part of franchisor expansion programs?

From a personal perspective, how do these legislative proposals affect my practice as a lawyer? I am a transactional lawyer, not a litigator, and initially I can see numerous inquiries from franchisors about the impact of such new legislation. But over time, I can see my clients moving away from aggressive franchise development and focusing more heavily on company-store openings. I can see the sources of new franchise programs drying up, in particular from larger corporations who previously had sought to trade on a valuable brand image by opening retail outlets and creating new forms of distribution. I can see the value of existing franchised businesses being significantly diminished because franchisors will be unwilling to continue franchising. In the end, I am confident that I will be busy, but I will be busy in court on behalf of clients facing an onslaught of litigation.

I would be happy to provide the Subcommittee with any additional requested information. Thank you for the opportunity to appear before you.

Mr. GEKAS. We thank you, Mr. Wieczorek.

Mr. Singler.

## STATEMENT OF PETER A. SINGLER, ESQUIRE, LAW OFFICES OF PETER SINGLER, SEBASTOPOL, CA

Mr. SINGLER. Thank you, Mr. Chairman, for the privilege of being able to testify this morning.

I am going to scrap my prepared statement because a number of my points were very well stated this morning and very articulately. And, Mr. Chairman, you adequately, I think, addressed how substantive and how important franchising is to this country. It affects every one of our lives every day, and I thank you for that.

I would like to clarify and respond to a few things that have come out in testimony this morning, however. But first what I would like to do is emphasize or just give you a little bit about my perspective. I am a lawyer; I am a business lawyer. I deplore litigation. My clients deplore litigation. It is costly; it is time consuming; it is distracting.

I wasn't going to do this, because I think this issue is bipartisan, and it should muster support from both sides of the aisle, but I am also a conservative. And so, when I think about these issues, I share Mr. Bryant's concern. How do I reconcile my adversity toward government intervention into private business with some of the proposals that have been made over the years, and will probably be made very soon?

Mr. NADLER. You can be paired with Mr. Adler.

Mr. SINGLER. Pardon me? [Laughter.]

Mr. NADLER. I said you can be paired with Mr. Adler, who is——

Mr. SINGLER. Well, like I said——

Mr. NADLER. A liberal Democrat who doesn't——

Mr. SINGLER. [continuing]. I wasn't going to do this, because I——

Mr. NADLER [continuing]. Want this legislation. [Laughter.]

Mr. SINGLER [continuing]. Don't think it is relevant, but to address—and I wish Mr. Bryant was here because I want to specifically address the same analogy, and that is the gun to the head.

And we will hear that more and more. And the longer this issue is discussed, we will keep hearing that analogy. There is one assumption, to have a gun put to your head, you have to be in the same room with the gunman, and that is where we never get. As franchisees, we don't even get into the industry, we don't even get into the room to have a gun put to our head.

And to clarify a little bit—it has already been discussed, but if someone wants to pick an industry—and just think of your own experience. Think of pizza; think of doughnuts; think of hotels. And write a list of every brand name that can come to the—right off the top of your head. You are going to probably pick, if not exclusively, a vast majority of those names are going to be franchise outlets or franchise systems.

Now, if you can want to take the time—and they are very tedious and very long—but if you want to take the time to read the franchise agreements within each of those industries, they are going to be substantially identical. Every one of the material terms that are problematic in a number of ways are going to be the same.

Is there a choice? Absolutely not, unless you are claiming that the choice is to enter into an industry altogether or choose not to.

Franchising dominates our retail economy. If I want to open a pizza restaurant, a hamburger joint, a hotel, a family amusement center, or what have you, my choice is, compete with a franchised system that has brand identity, built-in brand biases for the public, or go it alone and recreate the wheel. So if I want to compete effectively in an industry, my choice is—and there is really no choice at all—I must sign a franchise agreement. And that is where it stops.

Mr. Adler said you are free to just pick another system with a better contract. And if you want to do your due diligence, go ahead and call all the other existing franchisees. One thing that happens in my practice—and, again, I represent exclusively franchisees and franchisee associations in my law practice. The vast majority of these people are long-time, very successful franchisees and are fairly sophisticated.

But I ask one question when a new client comes into my office, and that is, if you weren't already in this system, would you do it all over again? The answer, without exception, has been, "Absolutely not." And it is usually followed with a statement, "But because of non-competition covenants, because of restrictions on sourcing, because of restrictions on transferability—on my ability to sell my business—I can't get out, and so I've got to make the best of it." And as a conservative, that really, really bothers me.

I have a commitment and a philosophical bias that our entire free enterprise system is based on just that, "free enterprise." And if you look through any of these—and Dennis writes great franchise agreements. I mean they are bulletproof. But as a franchisee, I look at that, and I commend you, but can he not say—and if the Chair wants to inquire of him later—can he not say that there are not just pages and pages and pages of restrictions on sourcing supplies in his average agreement, restrictions on competition? This is an affront to our basic premise of free enterprise.

My time is up; thank you very much.

[The prepared statement of Mr. Singler follows:]

PREPARED STATEMENT OF PETER A. SINGLER, ESQUIRE, LAW OFFICES OF PETER SINGLER, SEBASTOPOL, CA

Thank you for your invitation to appear before the House Subcommittee on Commercial and Administrative Law. I believe this is a great privilege and look forward to testifying about the current status of franchising in our Nation. The influence that franchising has, and will continue to have, on our economy is indisputable. It is currently estimated that by next year, 50¢ of every retail dollar spent in the United States will be through a franchised outlet. Franchised outlets account for billions of dollars and millions of jobs in our economy.

I am a business lawyer. The majority of my practice is devoted to representing franchisees and franchisee associations. I am also a director and major shareholder in a company my father started over 35 years ago, whose primary business is the operation of Round Table Pizza Restaurant franchises. As both a lawyer and a small business owner, I have three general concerns regarding the enactment of legislation:

(1) Will the legislation create more litigation or standardize legal premises to alleviate legal disputes?

(2) Will the legislation promote free-trade?

(3) Will the legislation interfere with my freedom to contract or make reasonable business choices?

As discussed below, establishing fair standards of conduct for franchise relationships will reduce litigation, promote free-trade and efficient competition, and protect my ability as a small business owner to contract freely with regard to my business.

Despite the dominant role that franchising plays within our economy, there are fundamental flaws in the basic structure of the institution. A gross disparity in economic strength and bargaining power between franchisors and franchisees has led to increasingly onerous contract provisions, and allowed some franchisors to engage in unscrupulous business practices. Such agreements and unfair practices are impeding entry into markets and stifling free-trade and competition. This is because an entrepreneur wishing to enter or advance within an industry has two choices: join a franchise system, or go it alone and compete with franchise systems whichpossess an overwhelming advantage. However, when determining which system to join, franchise agreements are substantively so alike that there is no real choice to be made. These agreements strip the prospective franchisee of many of the protections one would assume to be built-in to any normal business relationship. Onerous contract provisions allow unscrupulous franchisors to deny their franchisees the realization of the goodwill and value they may have invested many years and their life savings to develop.

In some respects, franchising is analogous to present day indentured servitude. If a franchisee is subjected to unfair treatment by his or her franchisor, there is little recourse. The franchisee generally lacks the relative strength to negotiate effectively. Because the contracts are so one-sided in favor of the franchisor, there is generally no legal recourse available. Because of non-competition covenants contained in most franchise agreements, the franchisee is not even free to leave the system and compete individually or associate with another franchise system which provides value, or deals fairly with its franchisees.

If a franchisee has the resources to challenge a franchisor's conduct in court, (s)he must face highly subjective and inconsistent treatment within the legal system. Because there is no Federal legislation establishing consistent standards, franchise agreements often contain choice of law and venue provisions which allow the franchisor to control both the substantive law which will control any dispute, and the place the matter has to be resolved. This means that a Nevada franchisee could be forced to litigate in Maine, and be subject to Illinois law. This "forum shopping" allows franchisors to insulate themselves from a number of meritorious lawsuits just because of the great expense and inconvenience a small business person would have to incur to vindicate his or her rights—even in the most egregious of cases.

Our courts have proved to be a costly and ineffectual avenue for resolving the flaws inherent in franchising. Despite the many inconsistent legal rulings, some courts have clearly identified the current inequities within franchising. For example, a California Court described many franchise agreements as contracts of "adhesion," containing "unconscionable" terms. (*Postal Instant Press, Inc.* v. *Sealy* (1996) 43 Cal.App.4th 1704). A United States Court of Appeals opinion went so far as to refer to a franchisor's agreement (which is similar in many material aspects to those of many franchise systems) as "commercially unreasonable." Unfortunately, the franchisee who was the beneficiary of this ruling had already been forced to file bankruptcy due to the franchisor's bad faith tactics. (*In re Vylene Enterprises, Inc.* v. *Naugles, Inc.* (9th Cir., 1996), 90 F.3d 147)

Although the FTC Rule is designed to promote adequate pre-sale disclosures, the FTC has been totally ineffective in promoting fairness and free competition in franchising. The FTC does not review any of the representations contained in the Uniform Franchise Offering Circular, and it investigates less than 6% of complaints alleging substantive violations of the rule. Furthermore, the Rule has no bearing on post-sale activities.

There is a great need for fair, universal standards for franchising. Federal legislation will alleviate the inconsistent treatment currently suffered by the application of piecemeal state law. Federal legislation will also ensure that the basic tenets of fairness and responsible business practices are a part of franchising. These results should encourage domestic investment within franchising, an institution which plays a vital role in our National economy.

Below, I have taken the liberty of discussing several issues which are prevalent throughout franchising. The gross disparity in bargaining power and the lack of meaningful choice franchisees are given when entering into industries dominated by franchise systems has led to wide-spread discontent and litigation. The contentious environment arising from these factors will chill continued investment and could eventually threaten our National economy.

*A. Post-Term Restrictions on Competition.* Most franchise agreements contain non-competition covenants which prohibit a franchisee from competing with a franchisor (directly or indirectly) or investing in or seeking employment from a competitor after the franchise relationship ends. The effect these types of covenants have upon free-trade and efficient competition is self-evident. Although a franchisor may have a legitimate interest in protecting its trademarks and brand image, there are already adequate protections in this regard, such as the Uniform Trade Secret Act. The very nomenclature of these types of covenants "restrictions on competition" indicate that they are an affront to this Country's strong policy favoring competition. The basis of free enterprise is to encourage innovation and allow entrepreneurs to move freely within the market place. We already have laws restricting the use of trade secrets . . . We need not prohibit franchisees from engaging in their livelihood to protect a franchisor's dominance in a particular market. Once a franchise is terminated, the franchisor is free to license a new franchisee in the same market area. The franchisee should be allowed to compete against its former franchisor.

*B. Duty of Good Faith.* There is nothing more basic in any relationship than the premise that each party will act reasonably and in good faith with each other party. It seems unimaginable that anyone would enter a relationship if they believed the other party would act contrary to this basic precept. Courts have commonly described the duty of good faith as follows:

> There is implied in every contract a covenant by each party not to do anything which will deprive the other parties thereto of the benefits of the contract. . . . [T]his covenant not only imposes upon each contracting party the duty to refrain from doing anything which would render performance of the contract impossible by any act of his own, but also the duty to do everything that the contract presupposes that he will do to accomplish its purposes. *Harm* v. *Frasher* (1960) 181 Cal.App.2d 405, 417.

The Restatement 2d of Contracts (section 205) agrees that the covenant (similarly described) is part of every contract, and lists examples of good and bad faith performance. The covenant of good faith and fair dealing is not only common sense, but a long-standing legal construct. However, as a myriad of recent litigation has demonstrated, this basic principle is not readily followed in the franchise context.

The covenant of good faith is "implied" into every contract. However, a general rule of contract interpretation is that an implied covenant will not overrule an express contractual term. Franchising is plagued with one-sided, oppressive contracts which completely favor the franchisor at the franchisee's expense. These agreements "expressly" reserve various rights for the franchisor, often including the right to establish a competing franchise in close proximity to an existing franchisee and to unilaterally determine the source of goods and supplies the franchisee must purchase. In effect, the franchisor expressly reserves the right to deny the franchisee the fruits and benefits under the franchise agreement, thus nullifying the effect of an "implied" covenant of good faith and fair dealing.

Simply stated, many courts have held that as long as a franchisor reserves s right, it need not act fairly or in good faith. Federal legislation can install a duty of good faith and fair dealing into the franchise context, thus protecting a basic tenet which is so obvious in our other business relationships that we often take it for granted.

*C. Duty of Due Care.* Franchisees, whether first time entrants into the marketplace or sophisticated refugees from down-sizing corporate America, often invest their life-savings and commit themselves to long hours of labor when they purchase their franchised business. When making the business selection, a prospective franchisee relies upon the business acumen of the franchisor, and the systems the franchisee will receive in exchange for the initial and ongoing fees (s)he will pay to the franchisor. Because of this, a franchisor should have to disclose its experience and skills within the industry. If the franchisor does not have the knowledge and skills commonly found within the industry, it should have to disclose that fact.

Requiring such a disclosure will allow prospective franchisees to make an informed decision regarding the franchisor and system to which they will pledge their livelihoods—Such disclosures will also give pause to the unscrupulous franchisor who attempts to sell franchises based upon hype rather than substance.

*D. Limited Fiduciary Duty.* Many franchisors undertake to provide accounting services or administer advertising funds under the terms of their franchise agreements. Franchisors generally acknowledge that the monies they are handling in these situations do not belong to the franchisor. Yet, at the same time, they also disavow any duty to account for these funds or deal in good faith. In the most basic legal terms, whenever one party undertakes to hold or manage the property of another, a "trust" is establish. The law imposes a standard of conduct upon anyone holding property in trust for another. Black's Law Dictionary defines a fiduciary as one "having a duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking." To ensure fair dealing and that franchisees' monies are handled properly, franchisors should be subject to the same standards and duties applied generally when one holds or manages the property of another. A limited fiduciary duty should apply when: (A) a franchisor performs bookkeeping, collection, payroll, or accounting services on behalf of the franchisee, or (B) where it administers or controls an advertising, marketing or promotional fund to which franchisees are required to, or routinely, contribute.

The recent Meineke case (*Broussard* v. *Meineke Discount Muffler Shops, Inc.*, 1998 WL 512926 (4th Cir. (N.C.)) aptly demonstrates the necessity for the limited protection suggested above. In the Meineke case, the trial judge was clearly disturbed by Meineke's use of the advertising fund (collected as mandatory contributions from franchisees). Meineke created an in-house advertising agency, and paid it significant commissions (over $17 million), essentially paying itself twice (administrative costs and commissions) with franchisees' contributions. The lower court found that Meineke as collector and administrator of the ad fund had a fiduciary duty to the franchisees not to enrich itself at their expense. The appellate court reversed, holding that under North Carolina law a franchisor has no fiduciary duty to its franchisees.

Commonly, franchise agreements disavow any duty regarding advertising funds, and the franchisees have no right to audit or check on how this money is being spent. On the other hand, these agreements also state that the money is not the franchisor's, but belongs to the "entire system." This is evidenced by the common practice of not taking advertising fees into income for tax purposes. If the money is not the franchisor's, then it is necessarily someone else's. This is the common definition of a "trust," holding or administering someone else's money or property. In all trusts, there is a fiduciary duty imposed upon the trustee to act fairly and reasonably with the trust funds, not to self deal, and to be accountable to the beneficiaries. Again, these same basic tenets should be applied in the franchising context when a franchisor is entrusted with franchisees' money.

*E. Transfer of a Franchise.* Franchisees and advocates of fair franchising legislation do not question a franchisor's interest in assuring that qualified operators own the franchised business within its system. However, if reasonable standards for experience, financial strength and ability to operate the franchise are met, a franchisee should be free to transfer the franchise according to the same terms and conditions under which the franchisee operates. Currently, if a franchisee wishes to retire, pass the business to his or her children or a key employee, (s)he is faced with burdensome and often capricious obstacles set by franchisors. Because a franchisor may expressly reserve the right to approve any transfer of the franchise, or any equity interest in the franchisee, the potential market of available buyers is greatly reduced. The smaller the market, the less the franchisee will realize on a sale of the business.

Another common provision in franchise agreements allows the franchisor to condition its consent to a transfer upon the buyer's signing the "then current" franchise agreement. The economic terms of franchise agreements have, across the board, become increasingly burdensome. Thus, the value of a franchisee's business will be greatly reduced if the buyer will have to pay higher fees, pay more for supplies or have other increased costs dictated by the franchisor. A prospective buyer will decrease the purchase price by the increased risk or cost associated with the new agreement, risks or costs which have, in effect, been created by the franchisor because of the proposed transfer.

The net effect of overreaching restrictions on transfer is to deny a franchisee the goodwill that (s)he may have spent years developing. In non-franchised businesses, an owner may offer to sell part or all of his or her business and the market will determine the selling price. In franchise systems, it is often the franchisor who determines who the buyer will be and, through the use of burdensome restrictions, the price that will be paid.

Federal legislation can promote market freedom and protect a franchisee's ability to freely contract for the sale of his or her business at a true market price. This can be done by establishing a franchisee's right to transfer his or her business upon substantially similar terms and financial requirements as in the franchisee's current agreement. The franchisor will retain the flexibility to alter the form of the agreement to address changing markets and conditions. At the same time, the franchisee's goodwill and the true value of the business will be protected from arbitrary manipulation. By allowing a franchisee to transfer his or her business upon the same economic terms under which (s)he operates, a franchisor will be receiving the same consideration for which it bargained when it entered the agreement. Without such protection, the franchisor receives a windfall at the franchisee's expense.

*F. Independent Sourcing of Goods and Services*. Many franchise agreements provide that the franchisor may designate the supplier and brands of goods and services used in the system. In effect, this creates a monopoly for the supplier to the system and often eliminates price competition. In addition, it is common practice for franchisors to receive kickbacks from suppliers to the system. Once again, these payments constitute a windfall to the franchisor at the franchisees' expense. By logical necessity, this *de facto* price fixing affects the franchisees' profitability, and at least to some extent, higher costs are passed-through to the consuming public. This current reality is exactly the type of situation that anti-trust legislation was designed to protect against. However, courts have been reluctant to apply such standards to the franchising relationship.

Once again, franchisees do not argue against the franchisor's legitimate interest in controlling quality and maintaining the secrecy of proprietary products. Reasonable standards for product quality may, and should, be established to protect these interests. However, if multiple suppliers can meet these standards, then franchisees should be free to contract with any qualified supplier and procure the best available pricing.

In addition, franchisors should be required to disclose and return to franchisees any rebates or payments received from vendors to the system. Payment of these kickbacks inhibits a franchisee's ability to obtain the best free-market price. Again, this situation hurts the franchisee's bottom line, but also increases prices to the consuming public.

*G. Encroachment*. There has been a great deal of litigation, ill-will and unproductive strains placed upon the franchisor/franchisee relationship due to encroachment—the practice of a franchisor opening or licensing a competing business under the same brand name in close proximity to an existing franchisee. As discussed above with regard to the covenant of good faith and fair dealing, franchisors commonly reserve the right to operate or license a business anywhere they want. Because of the contractual reservation or right, courts are often unwilling to intercede on the franchisee's behalf, even when the franchisor's conduct effectively drives a franchisee out of business. This was illustrated by the court's statement in *Camp Creek Hospitality Inns, Inc.*, v. *Sheraton Franchise Corp.* 130 F.3d 1009 (C.A. 11th Cir., 1997): "By the express terms of the contract, therefore, Sheraton could have authorized a competing franchise directly across the street from the Inn, and Camp Creek would have little recourse."

The inequality between franchisors and franchisees has resulted in franchise agreements in which franchisors reserve their rights to locate new franchises wherever they decide. Who, with true freedom to contract, would agree to pay a franchise fee for the right to use a brand name and system, only to have the franchisor accept another fee from another franchisee to open the same business next door? Where parties have some equality they can negotiate a reasonably balanced relationship. Where one party has all the power, it can impose an agreement which reserves all the power for itself. This currently happens in many franchise systems.

The encroachment issue is only exacerbated when one considers the other provisions commonly found in current franchise agreements. For example, most franchise agreements contain both non-competition covenants and a reservation of the franchisor's right to directly compete under the same brand name anywhere it wants. Thus, the franchisor can compete with its own system, but the franchisee cannot. If the franchisee finds the relationship too burdensome, s/he is free to leave after the franchise agreement expires, however, s/he may not engage in the only trade or industry in which the franchisee can make a meaningful living. This is despite the fact that the franchisor is free to re-franchise the area and continue to operate its business in the franchisee's former market. This double standard exemplifies how onerous current franchise agreements can be, as well as the threat that these agreements pose to the continued growth and prosperity of franchising as a whole.

In conclusion, Federal legislation establishing fair and reasonable standards of conduct for franchising is urgently needed to protect a vital facet of our National economy. These standards will ensure that entrepreneurs and small business owners have a meaningful opportunity to freely contract and enter into various industries upon commercially reasonable terms. These standards will also promote free-trade and efficient competition within the economy, affording both franchisees and the consuming public the benefit of best-market pricing. Federal standards will eliminate the disparate treatment caused by piecemeal state legislation in the franchise area. Clear standards of conduct will also greatly reduce the amount of costly and unproductive litigation by franchisees desperately seeking recourse from oppressive and unfair treatment by certain franchisors.

There should be little objection to fair National standards for franchising by franchisors who deal fairly and honestly with their franchisees. If a franchisor opposes Federal fair franchising legislation and protections being afforded small-business owners, the motivation behind such an objection should be scrutinized. More likely than not, those in opposition will be the franchisors currently engaging in unscrupulous practices and taking unfair advantage of their disparate bargaining power.

I would again like thank Chairman Hyde, Chairman Gekas and the distinguished members of this Subcommittee for allowing me the privilege of submitting this statement and offering testimony on this important subject. I hope that the Subcommittee will carefully consider fair franchising legislation once proposed, and will move expeditiously to refine the legislation and forward it to the Judiciary Committee for further hearings and action. If I can be of any further assistance to the Subcommittee or staff, I will be happy to make myself available.

Thank you.

Mr. GEKAS. We thank the gentleman. The time has expired.

[Applause.]

We will ask that the people in the room do not demonstrate one way or another through any portion of the testimony or the commentary.

Mr. Tate now will wind up testimony of this panel.

## STATEMENT OF LARRY I. TATE, ESQUIRE, VICE PRESIDENT OF FRANCHISING, GOLDEN CORRAL CORPORATION, RALEIGH, NC

Mr. TATE. Thank you, Mr. Chairman.

Franchising has been my life for 36 years, starting in 1963 as general counsel, the first in-house general counsel for Baskin-Robbins Ice Cream, working for 7 years with the 2 co-founders, Mr. Baskin and Mr. Robbins.

In 1978, I left corporate life as executive vice president of Shakey's Pizza, to fulfill my dream of owning my own business as a franchisee of four Shakey's Pizza Parlors in Los Angeles. For 6 years, I was personally involved in the day-to-day operation of my restaurants, and I was named "Franchisee of the Year," for having tripled the business.

So being both a franchisor and a franchisee, I think, has given me a unique prospective from both sides of the fence.

Golden Corral strongly supports the current Federal Trade Commission disclosure rule—our uniform franchise offering circular is a 250-page document, plain English, easy to read. It is all inclusive, with 22 categories of information, including litigation history, financial statements, investment costs, earnings claims, and a complete list with names and addresses and telephone numbers of all of our franchisees, past and present. We believe this information is complete, and that no additional disclosure should be required.

Bills have been introduced in the past to further regulate and change franchisee/franchisor relationships. If enacted, they would have modified the franchise contracts of over a quarter of a million franchisees.

In the minute or two I have remaining, I would like to address briefly several of the many objectionable provisions in past bills that are likely to be reintroduced.

The implied covenant of good faith sounds like motherhood and apple pie, but it threatens the fundamental legal right of freedom to contract. Good faith is implied by the courts today in any document or contract where the terms are unclear, where the contract has not specifically addressed the issue. But when an agreement is executed, it defines the contract relationship. The courts have consistently refused to imply any additional terms where the agreement itself clearly covers the issue in the contract, and there is nothing unclear.

In the restaurant business, it opens up the Federal courts to ask the judge and jury to decide what is "good faith" in the collection of royalties, in the inspection of restaurants, the criteria for approving real estate sites, the criteria for new franchisees entering the system, or what is a "good faith" exercise of default and termination conditions. There will be as many definitions as there are judges and juries, and neither franchisees nor franchisors will know what their contracts really mean.

Also, franchisors need flexibility to address franchisees' needs in a case-by-case basis. This would be considered discriminatory under past bills. The franchisor may delay royalty payments for good reasons, or put royalties past due in a promissory note with a year to pay in the event of a temporary cash flow problem.

At Golden Corral, we loaned money to a franchisee in one instance, whose business suffered a major downturn because of a food-borne illness incident over which they had no control.

Special arrangements like this would be curtailed or completely eliminated because of the risk of being taken to court by another franchisee demanding special terms or loans, charging a lack of good faith or discriminatory treatment.

There are examples, unfortunately, of tragic losses by franchisees. These companies should be held to answer for any wrongdoing and damages, but adequate remedies exist today in Federal and State courts through class actions, suits for damages and complaints to the Federal Trade Commission, who report that they receive less than a fraction of 1 percent complaints, based on over 300,000 franchises in the U.S.

To sum up, my experience as a franchisor and a franchisee has shown me that additional government regulation and restructuring of franchise relationships is not needed. The changes proposed in past bills would disrupt and confuse existing franchise contracts, would destabilize 40 years of case law precedent and flood the Federal courts with suits. The result will burden existing small businesses, both franchisees and franchisors, and stunt the future growth of franchised small businesses which will limit opportunities in the future for women and minorities to achieve their dream of owning their own business.

I would be happy to answer any questions. Thank you.

[The prepared statement of Mr. Tate follows:]

PREPARED STATEMENT OF LARRY I. TATE, ESQUIRE, VICE PRESIDENT OF FRANCHISING, GOLDEN CORRAL CORPORATION, RALEIGH, NC

My name is Larry Tate. I am vice president of franchising for Golden Corral Corporation headquartered in Raleigh, North Carolina. Golden Corral is a privately owned company with 450 family restaurants in 38 states—150 units are company owned and 300 are franchised. We are the largest and fastest growing "steak, buffet and bakery" chain in the nation opening a new restaurant on the average of one every nine days, with systemwide sales in 1998 of $861 million, an increase of 12% over 1997 sales.

I am pleased to have this opportunity to testify before the committee because franchising has been my life for the past 36 years. Starting in 1963 as general counsel for Baskin-Robbins Ice Cream, I have worked in senior management positions at Orange Julius International, Manpower, Inc. and Shakey's Pizza, in addition to my present employment for the past 15 years at Golden Corral.

As a franchisor, I helped others realize their dream of becoming business owners, by encouraging them, educating them, and providing them with experience and resources they needed to be successful. It has given me pleasure as a franchisor to see my franchisees leverage our joint efforts to help bring their personal and business goals to fruition.

In 1978 I left corporate life for six years, to fulfill my dream of becoming a franchisee owning and operating my own franchised business. After 15 years of coaching from the sidelines, I decided it was time for me to go on the field and realize that dream myself.

I left the ivory tower as executive vice president of Shakey's and from 1978 to 1984 I lived in Burbank, California, where I owned and operated four Shakey's Pizza restaurants in the Los Angeles area. I followed the franchisor's operating system and was personally deeply involved in the business everyday. I knew my customers and they knew me and I worked hard to meet and exceed their expectations.

I tripled the business and was named Franchisee of the Year. My experience as a franchisee was good, although there were some rubs when the franchisor opened new restaurants near my trading area. I might still be in Burbank with my restaurants were it not for the loss of my wife of twenty-four years to cancer and the need to begin a new life, which brought me to Golden Corral in Raleigh in 1984 where I established the Golden Corral franchising program.

I mention my background as both a franchisor and as a multi-unit franchisee for six years, because it has given me a unique perspective from both sides of the fence on the franchisee/franchisor relationship.

When I was beginning my career in franchising as general counsel for Baskin-Robbins Ice Cream in 1963, I thought my University of Michigan law degree and membership in the California Bar would equip me well to work with our 31 Flavor franchisees. In all candor, my lawyerly thinking was often at odds with the entrepreneurial spirit of small business owners and I quickly changed my mindset to respect and respond to franchisees' business needs and realities.

Today over 40% of all retail goods and services are sold through franchise systems. This percentage will soon be over 50%. Clearly business format franchising has been a resounding success. In 1960 franchising was a new and dynamic strategy for growth of small businesses. There were some abuses and questionable practices in the 1960's and 1970's. There were franchisee failures resulting from franchisor's being under-capitalized, poorly managed, or failure of the concept itself. There were a few dishonest and unscrupulous franchisors who solicited franchise fees from unsuspecting franchisees and disappeared with the money or failed to perform their obligations. Suits were filed based on contract fraud and misrepresentation in federal and state courts. Damages were awarded though not always collectible. Criminal charges were filed in extreme cases of fraud.

As a result, regulations governing the offer and sale of franchises were enacted at the federal level covering all 50 states. In addition certain states adopted their own requirements for the sale of franchises. Over time it became clear that obtaining full information about the franchisor and that company's business opportunity was the key to a prospective franchisee making an informed and intelligent decision.

Often the prospective franchisee did not know the right questions to ask or could not rely on the truthfulness of the answer.

In 1979 after several years of debate, the Federal Trade Commission implemented rule 46 requiring franchisors to provide prospective franchisees with a disclosure statement called an offering circular containing specific information about a company's franchise offering. It contained the answers to all the questions a prospective franchise should ask.

The rule has two objectives: to ensure that prospective franchisees have sufficient information to make an educated investment decision, and to provide them with adequate time to do so with a ten day waiting period before signing.

Golden Corral Corporation strongly supports the current FTC disclosure rule. The rule requires comprehensive and very detailed information be provided. The Golden Corral Uniform Franchise Offering Circular is a 250 page document. We believe that no additional disclosure is needed beyond the all-inclusive 22 categories of information currently required, which are:

1. The Franchisor, Its Predecessors and Affiliates. A description of the business, including its name, place of business, products, affiliations, etc. over the previous 15 years.
2. Business Experience of the Franchisor and Its Executives. A background of the executive and sales people associated with the company.
3. Litigation History with Cases Identified by Court and Number. Any administrative, criminal, or civil action against the company or its executives.
4. Bankruptcy. History of bankruptcy by the company or its officials.
5. Initial Franchise Fee. Any recurring or isolated fees, including leases, royalties, advertising fees, training fees, etc.
6. Other Fees. Any recurring or isolated fees, including leases, royalties, advertising fees, training fees, etc.
7. Initial Investment. Including real property, equipment, inventory, etc.
8. Restrictions on Sources of Products and Services
9. Franchisee's Obligations to Franchisees to Purchase or Lease in Accordance with Specifications or from Approved Suppliers.
10. Financing Arrangements Available. Whether the franchisor or an affiliated company offers financing arrangements for the franchisee.
11. Franchisor's Obligations to Franchisees. Including training, advertising sign placement, store construction, remodeling, etc.
12. Territory Available for Development. Whether the franchisee has the right to develop additional stores in an area or whether the franchisor can open company stores in the area.
13. Trademarks Owned by the Franchisor
14. Patents, Copyrights, and Proprietary Information
15. Obligation to Participate in the Actual Operation of the Business
16. Restrictions on What the Franchisee May Sell. Whether the franchisee is limited in the goods or service it can offer or limited in the customers to whom it may sell its goods or services.
17. Renewal Termination, Transfer and Dispute Resolution. The term of the franchise agreement and terms under which it can be renewed, terminated, etc.
18. Public Figures Involvement if Any. Any public figures that promote or endorse the franchisor's goods or services and the amount of compensation given in return.
19. Actual, Average, Projected or Forecasted Franchisee Sales, Profits or Earnings (Optional). If given, it must have a reasonable basis.
20. List of Outlets With Names of Franchisees, Addresses and Telephone Numbers
21. Financial Statements Showing the Franchisor's Balance sheet and Income
22. Contracts—Copies of Each Document a Franchisee Will Sign

Prospective franchisees study and depend upon these key categories of information required by the Federal Trade Commission Rule, which is further expanded upon by a number of state registration laws.

The most effective way to choose a good business investment is to study the information in the disclosure document and to perform other due diligence contacts with current and former franchisees of that chain to determine their level of satisfaction.

Then an intelligent and informed judgement can be made about that franchise business opportunity investment.

Bills have been introduced in Congress several times in this decade to further increase regulation of franchising and legislate changes in franchise agreements. These efforts have been well intended, but upon close review the fact is that existing laws and regulations are adequate to address abuses when they arise.

In recent years, Congressman La Falce of New York has several times introduced bills which contained a number of provisions to address franchisee issues and redefine the franchisor/franchisee relationship, which would have had the effect of substituting federally-mandated provisions for the terms and conditions of franchisee relationships now determined by the parties. These bills were not enacted.

In the second session in 1998, our neighbor Congressman Coble of North Carolina introduced another franchise disclosure and relationship bill, which was not considered. However, Congressman Coble indicated to me last week in a meeting with a group of North Carolina business people who were expressing grave concern about his bill, that he planned to reintroduce his bill this year.

H.R.4841 of the 105th Congress is virtually identical to legislation introduced by Representative La Falce which has been rejected after extensive hearings by every Congress since 1991. I'd like to address very briefly a number of the provisions in past bills that are likely to be reintroduced.

1. *Private Right of Action in Federal Court*—Create a private right of action in federal court for any "dispute" under the bill with no monetary threshold. For example, a disagreement over a restaurant inspection performed by a franchisor for quality, service and cleanliness could land in federal court claiming the rules were not applied in "good faith." Presently there is access to bring suit on contract issues for franchisor non-performance in federal and state civil courts for damages or specific performance and in criminal courts in extreme cases, in addition to complaints filed with the FTC.
2. *Implied Covenant of Good Faith*—A fundamental legal right in our democratic system of free enterprise is freedom to contract. When parties negotiate and agree upon and execute a contract, that contract determines and defines their relationship. The courts have consistently upheld this rule of law, declining to imply any term or provision as an addition to the agreement, where the agreement completely and specifically addresses an issue in the agreement itself.

   Introducing the question of what is good faith in the inspection of restaurants, the collection of royalty fees and other financial obligations, the approval of franchisees to enter the system, the conditions under which a default is declared or an agreement is terminated will cause a proliferation of litigation and as many definitions of these issues as there are judges and juries. Application of "good faith" provisions of the Uniform Commercial Code regarding the sale of goods in interstate commerce are inappropriate in a complex franchise relationship.
3. *Prohibits Locating a Future Unit Within Unreasonable proximity to Any Existing Units*—No standard to follow here. Judge and jury must decide. Agreements in effect today either provide a specific protected area or clearly state the franchisor awards a license to a franchise at a specific site and reserves the right to locate future units at their discretion. The actual practice of a company in exercising this discretion is what the prospective franchisee must investigate before signing up.
4. *Prohibits Franchisor From "Discriminating" Against Similarly Situated Franchisees*—Franchisors need the flexibility to address franchisees needs on a case by case basis. A franchisor may agree to delay royalty payment in certain circumstance or allow a franchisee to sign a one year promissory note for royalties because of a temporary cash flow problem. In one instance at Golden Corral we loaned money to a franchisee whose business suffered a major downturn after a food borne illness incident over which he had no control.

   Special arrangements of this kind may be curtailed or completely eliminated to our franchisee's disadvantage because of the risk of the franchisor being taken to federal court by other franchisees demanding special financial terms or loans claiming lack of good faith or discriminatory treatment.

   There are many other provisions which are of concern but in the interest of time and space I will not address them today. There are tragic examples of franchisor abuse of the relationship and those companies should be held to answer for their wrong doing, but adequate remedies exist today in civil contract actions or class actions for damages in state or federal courts.

To sum up, my experience on both sides of the franchisor and franchisee relationship has shown me that additional government regulation of franchising is not needed. The changes proposed would instead become disruptive of existing franchise contracts, destabilize 40 years of franchise case law precedent and flood the federal courts with suits, further burdening existing small businesses and inhibiting the future growth of franchised small businesses which will limit opportunities for women and minorities to achieve their dreams of owning their own business. In short, if it ain't broke, don't fix it. Thank you.

Mr. GEKAS. We thank you.

And the Chair now yields itself 5 minutes for a round of questioning.

Mr. Bates, when you first gave that statistic that 32 percent of franchises seemed to fail, then I was expecting when you were going to come in with the independent—or was it 38 percent?

Mr. BATES. Thirty-eight percent.

Mr. GEKAS. Thirty-eight percent. That 32 percent on the independent business closure ratio—were you shocked? I thought they were pretty similar. Maybe I am underestimating the 6 percent difference, but it doesn't seem to be a startling difference in the failure rate.

Do you still feel that it is startling or necessary for comment, that difference?

Mr. BATES. It is startling because the new franchisees are so much more heavily capitalized.

And if you were looking at two firms of identical size and capitalization, then that gap would be much, much wider than the 6 percent. The failure rate for the franchisees would be more on the order of 50 percent higher, controlling for firm size and capitalization.

Mr. GEKAS. Mr.—let me see—Mr. Singler, the emphasis that you put on what you considered a flaw—or at least you criticized the inability to resale, on the part of a franchisee. Do you believe that that is strong enough of a concern on your part that it should be translated into a statutory prohibition against a franchisor from prohibiting resale of a franchise enterprise?

Mr. SINGLER. Mr. Chairman, I—if I can maybe recharacterize your question, because I think there are two issues involved. And, as both a franchisee, and as a franchise lawyer, I acknowledge—and I think it is very healthy requirement that a franchisor protect the brand and protect the system by controlling who operates the franchise. There have to be standards of quality and standards of performance.

And so neither in my personal opinion, nor in Coble-Conyers, is there anything in there that restricts that ability.

Now, how that ties to the transfer issue—and this raises yet another sub-issue. The transferability provisions that are normally found in most franchise agreements generally restrict transfer of an interest in, or the sale of the business without the franchisor's prior consent. Sometimes that consent can be withheld in its absolute sole discretion, and sometimes the contracts say it will not arbitrarily or unreasonably withhold this consent. But—the standards by which they measure whether or not someone is fit to accept the business, or receive the business, are generally highly subjective.

And so the questions are this—and these show the interplay with—we have several things.

One is, if you are not happy with the system, the basis of our free enterprise system says you should be able to move and find a better mouse trap, compete freely in the marketplace. However, if there are these restrictions on sale and transfer, the franchisor basically gets to dictate to whom you may sell that business. And what is also common in these provisions is the franchisor's ability to change the contract upon transfer. And so if fee structures, franchise fees, or things like that increase in the interim, the contract rights you're selling are significantly more burdensome than the ones you are operating under. In other words, the value of your business has been drastically reduced.

Mr. GEKAS. But my question was, do you believe that the Congress should prohibit franchisors from prohibiting resale? Should we legislate that?

Mr. SINGLER. From prohibiting resale—no, I think resale should be allowed. Franchisors should retain the ability to resale——

Mr. GEKAS. I know. I am saying, do you wish statutory law that enables franchisees, not withstanding franchise agreements, to resale with or without—well, let's say, with the consent of the franchisor?

Do you think that should be put into a statutory language?

Mr. SINGLER. Yes, I do.

Mr. GEKAS. Mr. Wieczorek, do you agree with Mr. Tate that to insert a good faith standard would be simply to do the obvious, that it is already part of the law of the land, particularly in equity matters, that that would only breed further litigation?

Mr. WIECZOREK. I absolutely agree with the position. And let me comment on some of the suggestions that have been made about the UCC.

First of all, the bills that have been proposed in the past have gone far beyond the UCC, have gone far beyond common law in definitions of good faith. Essentially, if you look at the prior bills, a contract becomes a nullity. There is no contract any more. A franchisee and franchisor have very little to rely on because of the duties of good faith, as they have been drafted.

Now the UCC only applies to the sale of goods, and, obviously, if franchise systems are involved in the sale of goods, then they would have to comply with the UCC. But keep in mind where the UCC came from. If I remember properly from law school, and that is the sale of goods is usually in the environment of purchase orders, invoices, really no contract at all. And the UCC was created with the concept of good faith to fill that gap, and that is to say to parties who really don't have contractual relations, other than small purchase orders or invoices. You have got to deal with each other in good faith.

Franchisors and franchisees, as you have heard, have extensive contracts that deal with a number of issues, and that gap doesn't need to be filled. The courts in the common law arena have said that they will apply the duty of good faith. Almost every State in the country, in reviewing franchise agreements, says they will apply the duty of good faith, but they will apply the duty of good faith only if the contract is either uncertain, unintelligible, or has a gap, and they will fill the gap.

Mr. GEKAS. The time of the Chair has expired.

We yield to the gentleman from New York.

Mr. NADLER. Thank you.

My first question is for Mr. Bates. Mr. Wieczorek commented that any legislation in this area would necessarily hurt franchises, and that would necessarily, in particular, hurt women and minorities because they do well under franchising.

Would you please briefly tell us from your research how women and minorities are faring under the current franchising system? Better than the average franchisee? Less well? The same—whatever?

Mr. BATES. My research has focused largely upon minority-owned businesses. And minority-owned businesses are under-represented currently among the franchisee population. And the minority-owned franchises that are out there tend to be somewhat smaller.

Exactly how this legislation would hurt minorities and women. specifically, is completely unclear to me. I fail to see the logical link.

Mr. NADLER. Thank you.

Let me ask Mr. Wieczorek—first of all, a quick statement.

In your statement, sir, you talked about the failure of bills in Congress and State legislatures, and that proves the nonnecessity of the bills. Well, the failure of legislation may prove that they are not necessary, or it may prove simply that the opponents have a lot of lobbying or financial clout to block them—or political clout to block them. Initially, this country shows that they repeatedly, every major—at social events and legislation—took a long time with a lot of failures en route, so you can't comment on the merits of legislation by saying it hasn't been adopted. It simply may comment on the political or financial strength of the opponents and the proponents.

In any event, you also said that the relationship is best left to the parties, and we shouldn't legislate at all. Then Mr. Singler has testified, and I think we have heard it before, that there are no choices. All franchises in a given field have the same contract provisions, and people are forced either to sign it as is or not. It is a contract of adhesion in that sense.

Would you briefly comment on that?

Mr. WIECZOREK. Sure. First of all, he complimented my ability to draft bullet-proof contracts, and I can assure you, they are fair from bullet-proof. They are litigated. But the contracts I draft vary widely. I may draft a contract that is 10 pages. I may draft a contract that is 100 pages. It depends on what the company desires, what they are looking for. And, obviously, in franchising, a dynamic industry with new entrants all the time, a young company, a new company, may very well come to me and say, "Let's look at the big company and see what their contract says. And then let's cut it back some. Let's try to make our proposal, our franchise, more advantageous, because then we can compete with them better."

I see that all the time. That is an everyday occurrence for me, in terms of contracts.

Mr. NADLER. So you don't agree with Mr. Singler when he says that someone who wants to exercise Mr. Adler's choice, if he doesn't like the one-sided provisions in company "A's" contract, can simply turn to—Mr. Singler says he can't simply turn to company "B" because they probably have the same restrictions?

Mr. WIECZOREK. I would say that the contracts vary all over the board. And with 1,000 or 1,500 contracts that are on file with State government people, those contracts could be examined— —

Mr. NADLER. Okay. Let me ask you— —

Mr. WIECZOREK. [continuing]. And they vary very, very widely.

Mr. NADLER. All right. And, finally, you testified that if we were to enact anything to put in good faith standards or UCC standards or whatever, or other provisions such as were in the prior bills or in the current bill that is under consideration, this would lead to a lot of litigation. The courts are overcrowded; it is terrible.

Do you think that business disputes, generally, should be barred from court? Is the freedom to contract undermined by allowing courts to hear business disputes? And if your answer is "no," why is it so different in the franchise area?

Mr. WIECZOREK. Well—first of all, I think that what franchisors and franchisees have determined is that the courts are probably the worst place to deal with each other. And, in fact, many franchise agreements—in many of the ones that I draft now have mediation or arbitration clauses in them. And those clauses are intended to get the parties in a forum where they can deal with each other and— —

Mr. NADLER. Excuse me, but when you draft such a clause— —

Mr. WIECZOREK. Yes.

Mr. NADLER. [continuing]. If the would-be franchisee disagrees, does he really—can he say, "I would rather eliminate that arbitration provision and allow access to the courts?" Or, you wouldn't change that contract— —

Mr. WIECZOREK. I have— —

Mr. NADLER. [continuing]. Provision for that person; would you?

Mr. WIECZOREK. I have contracts that say—some require arbitration, some require mediation, some provide for neither. It is really a question of what the franchisor wants to accomplish— —

Mr. NADLER. Exactly— —

Mr. WIECZOREK. [continuing]. And its market position— —

Mr. NADLER. [continuing]. For the franchisor.

My question was, if a would-be franchisee saw such a provision and said, "Gee, I love your contract, all 100 pages of it, and I love your company, and I really want to do this, but, you know, just in case for the future, I don't want this arbitration provision." Is it your experience that that arbitration provision would be removed from the contract?

Mr. WIECZOREK. I would say to you that in rare circumstances it would be removed— —

Mr. NADLER. In rare circumstances?

Mr. WIECZOREK. But, the franchise—in rare circumstances— —

Mr. NADLER. Yes.

Mr. WIECZOREK. [continuing]. In negotiations. But if the franchisee dislikes that provision, he can go to company A, B, C, D, or E, and say, "Do you have a better contract? I want to use that contract."

Mr. NADLER. Can I have one additional minute?

Mr. GEKAS. The Chair yields another minute.

Mr. NADLER. Thank you.

Mr. GEKAS. I hope that that is the last minute.

Mr. NADLER. It is the last one. [Laughter.]

I just wanted you—you didn't answer my basic question which was, do you think that business disputes generally should be barred from court? And is the freedom to contract undermined by allowing courts to hear business disputes? And why are franchises, in this respect, different from all other business arrangements?

Mr. WIECZOREK. I think that the access to courts is widely available now. Franchisors and franchisees, particularly franchisees are able to utilize the courts now to redress their grievances, and I do not see anything in the new bill that would do anything other than increase the parties' likelihood that they are going to litigate, and decrease the likelihood that they are going to talk and communicate with each other.

Mr. GEKAS. The gentleman yields back the balance of his time, and we now allot 5 minutes to the gentleman from Ohio, Mr. Chabot.

Mr. CHABOT. Thank you, Mr. Chairman.

This has been a very interesting hearing. I think all the witnesses in both panels were quite good, and we are on a relatively tight timeframe here because we got a vote on—[Laughter.]—and so I probably won't take the 5 minutes, but just a couple of questions.

It seems to me that many of the franchisees who support additional regulation of franchising, many have been unsuccessful in the operation of their franchise business. I am sure that is not universal, but that seems to be, from what I have heard, a fair number of them had problems for one reason or another. And that many of the successful franchisees, at least for the most part, are not in favor of additional regulation.

Would any of the members of the panel like to comment on that very briefly—because I have just a couple more questions?

Mr. SINGLER. I would like to comment, and I would say, at least in my experiences and my practice, that is absolutely untrue.

We have a few franchisees who failed, and if we take a case on we try to access that the reason they failed, to our satisfaction, is something that the franchisor did. It was not the franchisee's inadequacies. The vast majority of my clients are very successful.

Mr. CHABOT. Mr. Wieczorek, would you want to comment?

Mr. WIECZOREK. I think that there is the—the problems with failure are the problems that any business faces in the United States. It is a competitive environment. It is difficult doing business against vertically integrated chains. A small entrepreneur with a franchisor trying to, as Mr. Adler said, fight off the Wal-Marts of the world, et cetera.

And the operational problems, I think that most franchisees out there, based on the satisfaction surveys you have heard about that the Gallop Poll did, would say that they are happy with their opportunity. And they would be unhappy if substandard operators—

people with operational problems—would be allowed to continue going.

Mr. SINGLER. May I make one more— —

Mr. CHABOT. It is also—I am almost out of time, because we have got to get over to vote. It is also—we have heard statements on really both sides about if this legislation passed that it would cause or create a situation in which there would be a significant increase in the amount of litigation and attorneys' fees.

And, again—maybe sticking to the two attorneys in the middle—would you comment briefly on whether or not you believe that is true?

And, secondly, how significant is additional legal costs on a business that may be starting out or perhaps maybe they have been in business awhile? But how significant are our legal costs?

Mr. SINGLER. As a business lawyer—and I don't know if you were here for my opening comments—I deplore litigation. And if I thought that any proposed legislation would increase litigation, I would certainly not be for it. It is very costly, both for the franchisor and for the franchisee. Setting a basic, reasonable, fair conduct—standard for conduct—should reduce litigation.

And the franchisees that are failing in the grievances we hear, franchisees, by and large, are terrified of retaliation. It is very difficult for them to associate. Franchisors try to find out who is—and if you heard Mr. Dunafon's testimony, as soon as he tried to form an association, he was blackballed, along with all the other leaders. And so that is part of the reason that you only hear from the failing franchisees. They are the guys that have just no other recourse.

Mr. CHABOT. Mr. Wieczorek, would you want to comment?

Mr. WIECZOREK. Franchisors undergo significant legal costs in getting started as franchisors. They have to prepare those thick disclosure documents we talked about earlier.

As far as litigation is concerned, I think those comments you have heard about reasonable standards of fair conduct, fairness, due care, I think all of that just lends itself to judges and juries being left with trying to flip coins over what is fair, what is reasonable, what is good, et cetera. And I think the likelihood of increased litigation, and people willing to take a crap shoot on litigating is much higher, based on the bills that we have seen proposed in the past.

Mr. CHABOT. Well, whatever we do, I think we certainly do not want to increase litigation, whichever way this ultimately goes. I practiced law for 15 years, but I am a "recovering lawyer" now, so—[Laughter.]

Mr. GEKAS. The gentleman yields back the balance of his time.

The time of this hearing has expired. We extend the warm gratitude of the Committee on the Judiciary, and the House of Representatives, and the Congress, in general, for the sacrifice that has been made by the witnesses who bring their testimony to the congressional record.

We thank you, and we dismiss you again gently. [Laughter.]

This hearing is adjourned.

[Whereupon, at 1:36 p.m., the subcommittee was adjourned.]

# APPENDIX

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## MATERIAL SUBMITTED FOR THE HEARING RECORD

Statement by Bruce J. Major

On Wednesday, June 23, 1999 Mr. Matt Shea called me and left a voice mail message that informed me that Mr. Darrell Dunafon was going to testify before a congressional panel. He noted that Mr. Dunafon would probably be critical of the industry and franchisors.

Also submitted with this statement and "transcription" of the voice mail Mr. Shea left is an audiotape of the conversation with Mr. Bruce Major on Wednesday, June 23, 1999.

*Hi, this is Matt Shea at the International Franchise Association in Washington D.C. I'm the Vice President and Chief Council. I'm calling you at one o'clock, Wednesday afternoon. My telephone number is 202-628-8000. I'd appreciate it if you could pass a message on to the appropriate person on your staff that Darrell Dunafon, who is a franchisee of yours, is going to be testifying at a congressional hearing tomorrow here in Washington We expect him to make critical remarks about franchising and about the systems for which he has been involved.*

I returned Mr. Shea's call and spoke with him on a speakerphone in the presence of Mr. Kevin Lamberson, which whose presence Mr. Shea knew. Mr. Shea asked me if I was aware that Mr. Dunafon was going to be testifying, and that he was going to be critical of franchisors. I advised Mr. Shea that Sandella's was aware that he was going to testify and that Sandella's encouraged his testimony. Mr. Shea then asked me if we were members of AFA. I said, "No, we are members of the IFA." Mr. Shea then went on about "the other side" wanting to create legislation that would create more government involvement. I told Mr. Shea that I had a problem with franchisors that have dozens of pages of litigation in the respective UFOCs overseeing the industry.

Mr. Shea seemed annoyed and frustrated with Sandella's position. Based on Mr. Shea's comments, and the substance and tone of his communications with me, I understood that Mr. Shea was trying to have me contact Mr. Dunafon and discourage him from testifying, which I would not agree to do. Basically, we agreed to disagree. I also told Mr. Shea I would be happy to sit on a panel to discuss this issue at length.

Bruce J. Major

Notarized: Kathy Gallaer
Kathy Gallaer
my Commission Exp.
5/31/2001

Statement by Kevin P. Lamberson

On June 24, 1999 I was sitting in Bruce Major's office at Sandella's Café when he returned a call to a Mr. Matt Shea. Mr. Shea wanted to know whether or not we knew that one of our franchisees, Darrell Dunafon, was testifying before a Congressional hearing in Washington, D.C. Bruce said, "Yes we were and we are proud of him for doing it." Matt then asked if we were members of the AFA to which Bruce responded, "No, in fact, we are a member of the IFA." Matt said that he was surprised that we were taking this stance and asked if Sandella's Café was concerned about what Darrell may say to hurt Sandella's and the industry. Bruce answered, "No, we are not. What Darrell is doing is to help the industry and protect it from franchisor's who have no concern for their franchisees." Matt then said that he had hoped "we" as the franchisor would talk with Darrell to discourage him from making the franchising industry more difficult to work in. Bruce said, "Why would I want to do that? So other companies who have pages of litigation in their UFOCs' against them from franchisees can tell me how I should treat my franchisees?"
The conversation ended with Bruce saying that he was going to listen into the hearing over the phone and see how things go.

Kevin P. Lamberson

Notarized: Kathy Gallas
Kathy Gallas

My Commission Exp. 5/31/2001

THE LEGAL SOLUTIONS GROUP, L.L.P.,
ATTORNEYS AT LAW,
*San Rafael, CA, July 14, 1999.*

SUSAN JENSEN-CONKLIN, *Esq.,*
*Subcommittee on Commercial and*
*Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

RE: *The Small Business Franchise Act*

DEAR MS. JENSEN-CONKLIN: I write to underscore the need for franchise legislation on behalf of the hundreds of franchisee clients I have represented previously and those whom currently represent. I have been in private practice representing franchisees for nearly twenty years, and I was formerly a staff attorney with the Federal Trade Commission enforcing its Franchise Trade Regulation Rule.

The Small Business Franchise Act is a statute whose time has come. Fairness and equity necessitate basic protections for the hundreds of thousands of franchisees in the United States. Their capital investment and their livelihoods, embodied in their franchises, mandate legislative protection.

Contrary to the claims of many franchisors, franchising is not over-regulated. Except for limited regulation regarding franchise sales, franchisors are instead hardly regulated at all. There is no federal regulation regulating ongoing franchise relationships, franchise terminations, or franchise renewals. And while several states have statutes addressing deception in the offer and sale of franchises, only a handful have franchise termination statutes. Only Iowa has sought to legislate standards regarding the franchise relationship itself.

The franchise relationship is now governed almost entirely by the adhesion contracts drafted by franchisors and their attorneys. Most franchise agreements are one-sided and unfair, and more often than not they are presented as non-negotiable form agreements. When even these agreements are occasionally construed in favor of franchisees, the ultimate result is usually a revision of the franchise agreement to delete the hard fought judicially recognized franchisee rights and remedies.

The view of franchise agreements as unfair adhesion contracts is not limited to Susan Kezios and other franchisee advocates. Instead courts have increasingly commented on the adhesion contract nature of franchise agreements. In the recent decision of the California Court of Appeal held that:

> Although franchise agreements are commercial contracts they exhibit many of the attributes of consumer contracts. The relationship between franchisor and franchisee is characterized by a prevailing, although not universal, inequality of economic resources between the contracting parties. Franchisees typically, but not always, are small businessmen or businesswomen or people like the Sealys seeking to make the transition from being wage earners and for whom the franchise is their very first business. Franchisors typically, but not always, are large corporations. The agreements themselves tend to reflect this gross bargaining disparity. Usually they are form contracts the franchisor prepared and offered to franchisees on a take-it-or-leave-it basis. Among other typical terms, these agreements often allow the franchisor to terminate the agreement or refuse to renew for virtually any reason, including the desire to give a franchisor-owned outlet the prime territory the franchisee presently occupies.
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> Some courts and commentators have stressed the bargaining disparity between franchisors and franchisees is so great that franchise agreements exhibit many of the attributes of an adhesion contract and some of the terms of those contracts may be unconscionable. "Franchising involves the unequal bargaining power of franchisors and franchisees and therefore carries within itself the seeds of abuse. Before the relationship is established, abuse is threatened by the franchisor's use of contracts of adhesion presented on a take-it-or-leave-it basis. Indeed such contracts are sometimes so one-sided, with all the obligations on the franchisee and none on the franchisor, as not to be legally enforceable.

*Postal Instant Press* v. *Sealy*, 43 Cal.App.4th 1704, 1716–17, 53 Cal.Rptr. 365 (1996) (citations omitted).

Unfortunately, courts have often chosen to enforce franchise agreements as written even while sometimes noting that the agreements are contracts of adhesion. Courts do not legislate. The need to address this issue is now acute and widespread. There are now over five hundred thousand franchisees in the United States. They employ over eight million citizens. Collectively, franchised businesses provide over forty percent of the retail goods and services purchased in our country. Franchise businesses invariably involve an investment of substantial capital. In many franchises the start up investment is well into six figures. Moreover, the lower investment sums in smaller franchises may nonetheless constitute a significant portion of the life savings of the franchisee.

The need to protect against fraud and deception mandates federal legislation in franchising just as federal securities legislation was promulgated to protect capital investors and to stop fraud in the securities markets. The impact on the American economy of franchising is on par with that of the securities market. Moreover, regarding securities fraud, the United States Supreme Court has repeatedly stressed the importance of private actions under the federal securities laws to provide deterrence and to redress injuries unremedied by governmental regulatory actions. *Deposit Guaranty National Bank* v. *Roper* (1980) 445 U.S. 326, reh. denied, 446 U.S. 947; *Phillips Petroleum* v. *Shutts* (1985) 472 U.S. 797, 809. Fraud and deception in franchising also mandates similar protections.

Franchising involves much more than a capital investment for most franchisees. A majority of all franchisees look to their franchises as their jobs. For these franchisees their franchise businesses not only involve risk capital but also risk livelihoods. When their franchises do not succeed, financial ruin often follows. Marriages fail. Homes are foreclosed. Bankruptcies are filed.

Federal legislation prohibiting fraud and deception in business practices has been enacted time and again including the Federal Trade Commission Act, and its Wheeler-Lea and Federal Trade Commission Improvement Act amendments, the federal securities laws, and other statutes. Similarly, federal legislation over the franchise relationship on its termination and nonrenewal have previously been enacted regarding particular industries such as the Automobile Dealers Day in Court Act and the Petroleum Marketing Practices Act. The time has come for federal franchise legislation.

Currently there is no private right of action under federal law to enforce violations of the Federal Trade Commission Franchise Disclosure Rule. The result, in many states, is that franchisees are left to common law fraud as their only remedy. Even in the sixteen states with franchise disclosure laws, the statutes of limitations may be short or the statutory remedies may be limited.

Common law fraud claims may often be difficult to establish, especially when based on oral misrepresentations which franchisors typically dispute vigorously. Moreover, many courts consider franchisor arguments based upon franchisor integration, no representation and no reliance clauses. These provisions are now standard in most franchise agreements and expressly deny the existence of any additional representations beyond the franchise agreement provisions and further deny that the franchisee relied on any such additional representations. To the extent these clauses are enforced by courts, one commentator has noted that they involve "deception condoned by denying that deception exists." Professor S. Cohn, *Deception Condoned: Pre-Contract Misrepresentation and the Parole Evidence Rule*, 12th Annual Society of Franchising Conference, p. 6 (March, 1998); see also, P. Lagarias, *The Misuse of Integration, No Representation, and No Reliance Clauses in the Name of Contract Certainty*, ABA Franchise Law Journal, Vol. 18, Number 1 (Summer 1998).

During the late 1970s the Federal Trade Commission held hearings which uncovered widespread fraud and deception in the marketing of franchises. As a result of the hearings, the Commission promulgated its Trade Regulation Franchise Disclosure Rule requiring certain truthful disclosures in the offer and sale of franchises. In its Statement of Basis and Purpose for the Rule, the Commission commented on the serious informational imbalance involved in the sale of franchises:

> The presence of such factors within franchising—i.e., the relative lack of business experience of most prospective franchisees, the highlighting of unusually successful franchisees by franchisors and the popular press, and franchisor representations that franchisees will personally direct the operation of their own franchise outlet serve to aggravate the informational imbalance present between prospective franchisee and franchisor by obscuring the serious financial risk which is entailed in the entering into of a franchise relationship.
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> Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, FTC Rule, Bus. Fran. Guide (CCH) Para. 6304. pp. 9211.Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, FTC Rule, Bus. Fran. Guide (CCH) Para. 6304. pp. 9211.

Unfair and deceptive trade practices continue to proliferate in court cases even among larger franchisors such as Minuteman Press and SpeeDee Oil. *See, Federal Trade Commission* v. *Minuteman Press*, Bus. Fran. Guide (CCH) Para. 11,516 (E.D.

N.Y. 1998); *People* v. *Speedee Oil Change Systems, Inc.*, Bus. Fran. Guide (CCH) Para. 11,548 (Los Angeles Sup. Ct. 1998). Numerous courts have, however, held that only the Federal Trade Commission may enforce the FTC Act and its Franchise Disclosure Rule. Thus, there is no implied federal cause of action for violation of the FTC Disclosure Rule.

One of the central problems arising from the nonexistence of a private right of action under the FTC Rule is the lack of sufficient Commission resources to prosecute alleged offenses. In 1993, the U.S. Government Accounting Office studied the Commission's enforcement of the FTC Franchise Disclosure Rule. The G.A.O. found that only six percent of the franchisee complaints lodged with the Commission resulted in FTC action. The G.A.O. Report concluded: "FTC has limited enforcement resources. As a result, some potentially meritorious cases may not get investigated or litigated. Also, the process can be slow. Each year FTC receives hundreds of franchise rule complaints, but it opens relatively few investigations and brings even fewer cases to courts." G.A.O. Report to the Chairman, Subcommittee on Oversight of Government Management, Committee on Governmental Affairs, U.S. Senate, Federal Trade Commission Enforcement of the Trade Regulation Rule on Franchising, pp. 3–4 (1993).

Even when the Commission takes action to enforce the FTC Disclosure Rule, it often does not seek relief on behalf of the injured franchisees. Thus, an FTC Disclosure Rule action by the Commission may result in a permanent injunction and a civil penalty against the franchisor, but no relief for injured franchisees. In only a few reported instances has the Commission obtained consumer redress for injured franchisees, and at best this is an issue of prosecutorial discretion involving limited government attorneys facing innumerable unfair and deceptive acts and practices in franchising and the economy generally.

A private right of action would allow the injured franchisees to obtain justice through damages. It is fitting and proper that defrauded or deceived franchisees who have lost their capital investment and their livelihoods in failed franchisees should be awarded damages. The anti-fraud disclosure rules in franchising should be subject to damages claims just as the anti-fraud rules of securities law. Legitimate franchisors, complying with the Franchise Disclosure Rule, should not fear this legislation.

A final and often expressed concern is whether a private right of action will lead to a flood of litigation. Currently franchisees facing financial ruin often sue for fraud and breach of contract. These claims, given the disclaimers and fine print in most franchise agreements, are often uncertain in outcome. With clear statutory prohibitions, however, miscreant franchisors will be more likely to settle both before and during litigation. More importantly defrauded and deceived franchisees will have a remedy.

Over one half million franchisees are in need of basic fairness in their franchise relationships. There is a need for fundamental fairness in franchising. no one can seriously challenge the need for anti-fraud provisions which are fully enforced. This requires a private right of action so that aggrieved individuals can sue to enforce the lâws and obtain redress.

The need for regulation of the franchise relationship and franchise terminations and nonrenewals is also dramatic and acute. There currently is no regulation of the relationship, and the result is the relationship is governed by one-sided adhesion contracts. This enormous share of our commerce, which has largely developed in the past quarter century, mandates basic fairness. Time does not permit my writing on these additional subjects now due to my court schedule. However, such provisions are needed and I will be glad to address these important subjects at future hearings. We look forward to the enactment of the Small Business Franchising Act of 1998 when it is reintroduced.

Very truly yours,

PETER C. LAGARIAS, *Esq.*

cc: Ms. Susan Kezios

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COTTMAN TRANSMISSION SYSTEMS, INC.,
*Fort Washington, PA, July 21, 1999.*

Hon. GEORGE W. GEKAS,
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR REPRESENTATIVE GEKAS: I am writing on behalf of Cottman Transmission Systems, Inc., a nationwide franchise company headquartered in Fort Washington, Pennsylvania. We employ more than 50 people here in our home office, and license more than 260 franchises in 32 states generating over $100 million in annual system wide sales. Nationwide our Centers employ thousands of skilled automotive technicians. We are the fastest growing transmission repair franchise in the United States.

I am writing to express our concern about the possibility of additional federal regulation of the relationship between franchisors and franchisees. At a recent hearing held by the House Judiciary Committee's Subcommittee on Commercial and Administrative Law, a few members of congress indicated an interest in reintroducing legislation that would impose additional restrictions on franchise relationships. We believe that such a law would have a significantly negative impact on franchise systems—the overwhelmingly majority of which are small businesses.

Many of the witnesses at the recent subcommittee hearing—including four former or current franchisees—raised the same concerns we have about additional regulation of franchise relationships. Namely, that franchising is already highly regulated at the federal and state levels; that sufficient protections exist to provide remedies for individuals who allege problems in their franchise relationships; that franchising is not an "industry" that can be uniformly regulated; and that additional regulations will restrict franchise growth and development. We believe those concerns are well-founded, and believe that additional regulation of franchise relationships would seriously jeopardize franchising, a primary component of the small business sector of our economy. In fact, this would hurt small start-up franchises the most as over burdensome regulation is one of the primary road blocks keeping very small businesses from franchising new concepts.

Franchising is not an "industry" that can be regulated in a "one-size-fits-all" manner. Franchising works because entrepreneurs who conceive of franchised businesses have the flexibility to structure relationships with franchisees in the manner moat effective for a particular brand, product, service or industry. The imposition of uniform requirements and prohibitions for franchise relationships in all industriea—restaurants, hospitality, real estate, automotive services, travel, printing—would be impractical, unworkable and highly counterproductive.

The fundamental impracticalities of this kind of legislation have been recognized by more than 30 state legislatures that reviewed and rejected similar legislation during the past decade. In addition, previous federal proposals introduced each congress since the 101st have similarly been rejected.

We believe that such legislation may be reintroduced in the House of Representatives in the near future. You may be asked to cosponsor this legislation and we strongly urge you not to cosponsor this ill-advised legislation.

Thank you for considering our concerns. If you would like to discuss this issue further, please feel free to contact me.

Sincerely,

TODD P. LEFF, *President.*

cc: Matthew R. Shay, Vice President and Chief Counsel—International Franchise Association

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PREPARED STATEMENT OF SPENCER P. VIDULICH, O.D., PEARLE VISION, CHICAGO, IL

I appreciate this opportunity to represent the views of the franchise community on this proposed legislation. I have been a franchisee in the Pearle system for eight years. I currently own three Pearle Vision Centers in the Chicago area and I am in the process of developing a fourth location. I also represent thousands of franchisees around the country as a director of our independent association of Pearle Franchisees, the Vision Care Franchisees Association (VCFA) and as a board member of the American Franchisee Association (AFA).

You will likely hear a lot of technical legal arguments on both sides of this issue, what I would like to do is to give you some idea of the mind-set of the typical franchisee and how the issues we are discussing affect a franchisee who spends his days in the trenches running his business. The first thing I want you to know about franchisees is that we, like most other business people, are very busy. This aounds quite simple and you may say; OK who isn't and what's this got to do with anything? Remember that we are small business people, mom and pop shops in many cases. Most other franchisees want nothing more than to be successful business people, for most of us this means seven days a week of not only servicing our customers but also dealing with all the administrative issues related to our businesses. Most franchisees therefore have little time to deal with what we are discussing here, namely the relationship issues which often become problematic between franchiaees and their franchisor, most of us don't have the time to come and talk to our representatives about these issues and truth be told most franchisees will try to deal with the problems they can fix on their own; that is, those that impact their day to day business operations. What this should also tell you is that franchisees are very practical business people, we believe in the power of free markets, we recognize the synergies and areas of mutual dependence between franchisees and franchisors. We do not want to waste our time and resources on nonproductive squabbles and litigation, we do, however, also recognize the areas where the interests of the franchisor and franchisee conflict and we know that we have little power on our own to negotiate these conflicts. That is why we seek the assistance of Congress to create these very incremental standards of conduct to guide franchise relationships. With these minimal standards of conduct in place franchisees will be able to more truly "partner" with our franchisors (our franchisors always remind us we are "partners") and use our existing communication channels more effectively to resolve conflicts. *If you learn nothing else from my testimony I hope it is the understanding that every franchisee would prefer to use the tools we trust you will provide us with to negotiate rather than litigate.*

There are those who testified on June 24th who characterized those seeking some protection of the property rights of franchisees as "whiners", as business failures who are seeking a free lunch from Congress. I have been a successful franchisee for almost eight years, yet I still believe it is necessary for Congress to address the vast imbalance of power existing in franchise relationships which puts at risk the investments of thousands of working families across the United States. Because of my relative degree of success—that is, I am not at immediate risk of default—and my visibility as a franchisee leader, I enjoy a degree of freedom to air my views. You can be assured that for every franchisee who contacts you in support of this legislation there are several on the brink of default who don't write for fear of retaliation. There were those who argued on June 24th that we didn't have a gun to our heads when we signed our contracts, but at renewal time, after a franchisee has built his business, he is faced with the prospect of signing a new, usually more restrictive and less favorable franchise agreement or walking away from his investment. That is when the gun becomes locked and loaded.

The central question to ask about franchising is; exactly what is one purchasing when one buys a franchise? The franchising industry through it's advertising, trade shows, salesmen and public relations army would certainly like the public, the consumers of investment opportunities if you will, to believe that they are making an investment in a business that will be their own. Yes, the franchise sales person will tell you, there is a lot of stuff in that agreement that doesn't sound so good but that's only for the "bad franchisees" and yes it does give us the right to open a store close to you "but why would we want to compete against ourselves?" Of course the earth bound reality of the franchise agreement is far different from the "sky's the limit rhetoric" of the sales pitch. The average potential franchisee, because of the overwhelming favorable public perception of franchising generally, are highly susceptible to this pitch.

Franchising, like much else in our country, has evolved beyond the storybook success stories of thirty or more years ago, but the public perception, exploited by the franchise sales force, is rooted in the image of the millionaire McDonalds franchisee of that bygone era. The truth is that, according to testimony provided June 24th by professor Timothy Bates of Wayne State University, franchise start ups have a higher failure rate than independent start ups.

The truth is that the franchisor has virtual total control of the net income (or loss) by a franchisee by virtue of the franchisor's control over franchisee economics. On the expense side of the ledger the franchisor dictates the cost a franchisee pays to buy into the system, royalty and advertising rates, the price of products sold to the franchisee and often times rental rates and other occupancy costs. On the income side, through national sales promotions the franchisor has a high degree of control over the prices a franchisee charges for goods and services (this control will likely increase with the recent Khan v. State Oil Supreme Court decision).Additionally, the placement of new locations in areas that encroach on the trading areas of existing franchisees has a direct impact on the gross income of franchisees. Through the manipulation of these economic levers the franchisor can arbitrarily and unilaterally tweak the system to maximize the profit of the franchisor at the franchisees expense. If the successful franchisees aren't as successful as they otherwise would be, so be it, if it causes a few too many franchisees to lose their stores through default, that's fine, the franchisor will get the store back and the former franchisee can be designated a "bad operator". This constant bind franchisees are placed in works doubly well by keeping franchisees in line. After all, who wants to risk speaking out against their franchisor when they're giving you more time to pay your royalties without defaulting you (even if it was the franchisor's bad acts that put you in this situation)? To many franchisors a franchisee who is highly profitable is one who's area must be ripe for some more locations, a franchisee who is marginally profitable is just right . . . He won't have the resources to come after the franchisor for damages. Most importantly, it is well known in franchising that franchisors don't encroach on unsuccessful locations, they move in on the successful ones. Such acts may not always destroy those businesses but they will, of course, decrease sales and absolutely damage the value of the franchisees asset.

Encroachment often takes the shape of a franchisor offering a current franchisee the right of first refusal on a new, nearby, location. The franchisor will tell the franchisee; "we'll consider offering you this location, but we are planning to put a new store here weather you want it or not" This is what I call the old franchisor "squeeze play". I know it well because it's what happened to me.

Franchisors leverage their own growth in a relatively risk free way through capital provided by the hard working men and women who become franchisees. These investor/business partners of franchisors currently have no protection against the arbitrary and abusive actions of their franchisors, there is no federal law which governs the conduct between large corporations which sell franchises and the small business people who operate them. The 1979 FTC rule governs only pre-sale disclosure and the FTC, according to a 1992 audit by the GAO, had, at that time, investigated only 5.7% of the *material* cases brought to it's attention. Were the franchisor to seek to grow it's business by instead obtaining capital through the debt or equity markets, those share holders or lenders would have a much higher level of protection for their investment than that enjoyed by franchisees.

The franchisor trade association, the International Franchise Association (IFA), would have you believe that franchising is a method of doing business to which standards of conduct can't be applied because of it's diversity, yet franchising seems to be uniform enough to be represented by a single trade association and to allow it's lawyers to produce ever more restrictive agreements which look remarkably similar across trademark lines. The IFA would have you believe it is very concerned about franchisees in general and opportunities for minorities in particular. Closer observation would reveal that these sentiments, which only developed after the formation of the American Franchisee Association, are, as is so often the case when one's lock on power is threatened, the last refuge of a scoundrel.

Franchisors crow that the standards of conduct we seek are too vague. They said in the hearing on June 24th that, and I paraphrase here, "a duty of good faith would cause irrevocable harm to franchising". The truth is that franchisors do not want to be held to even these minimal standards of conduct while at the same time they want to be able to hold themselves out to potential franchisees as ideal business partners. The height of this duplicity is the unwillingness of franchisors to provide franchisees with a reasonable territorial protection while at the same time most franchise agreements prevent a franchisee from the operation of a remotely competitive business at any location during the term of the agreement and within a specific area after the term of the agreement. Is not what's good for the goose good for the gander? Franshiors also complain that this legislative proposal would prevent them from helping out franchisees in distress, there is nothing in last years Coble-Conyers bill that would prevent them from doing so. It was interesting to hear Mr. Adler "whine" in the hearing on June 24th that if these measures are enacted they will cease to franchise because he will need more lawyers. Where is the evidence of this? The franchise relationship act currently on the books in Iowa has not resulted in increased litigation, franchising is alive and well in that state. With the increased uniformity this bill would provide, franchisors, like Mr. Adler, would likely be able to greatly reduce legal and administrative costs. The sky has not fallen on franchisors with the Iowa legislation and these federal proposals like Coble-Conyers would not be any different.

I would also respectfully ask the members of the committee to question the constituencies of witnesses Ms. Arleen Goodman and Mr. Lawrence "Doc" Cohen, although they tout their credentials as franchisees they are not, to the best of my knowledge, current franchisees. Whose interests are they representing?

The Coble-Conyers legislation was not about regulation, it would *not effect existing contracts*, it was, and still is, about establishing minimal, base line codes of conduct between large franchisors and the small business people who invest with them. It is about protecting the property rights of the franchisee. Franchisors should either embrace the fairness this legislation would inject into the franchising industry or come clean with the public about the truth of franchising. Franchisors, like many business people, will always take an unfair advantage if you let them have it. This legislation, with your support, will level the playing field.

## Confessions of an Ex-SOB Franchisor

BY ROBERT C. HAZARD, JR.

For 20 years I headed two of the largest franchise lodging chains in the world and worked with thousands of franchisees. Now I am a multi-unit franchisee myself with 10 hotels open and plans to build or buy 40 more franchised hotels under a variety of brand names over the next three years.

While President, Chairman and CEO of Choice Hotels International and CEO of Best Western, my job was to treat our 6,5 00 franchisees or members fairly, to maximize their profitability and to make them my *"partners for profit."*

Now that I am a franchisee, I have found that franchisors' rhetoric and today's reality are clearly out of sync. When I pay my franchisor 9 to 10% of my gross revenues (compared to half that amount 20-years ago) I'm really paying my franchisor 40 to 50% of my net profits. Even worse, the franchisor takes his fees off the top, while the franchisee may lose money on his bottom line. Each time I raise my room rates 4 to 5%, my franchisor gets a 4 to 5% raise. In addition I take all the financial risk while the franchisor takes none. Over the course of a 20-year agreement, I will pay my franchisor $2 million per hotel or more than $100 million for my 50 hotels. That's a good deal for my franchisor partners!

My franchisors provide me with a recognized and respected brand name, a productive reservation system, national advertising, marketing support, a quality inspection program, architectural prototype plans, purchasing assistance, training and limited operations support. We share a common bedrock belief that both of us have the same vital interest in strengthening the brand, improving quality standards, rapidly terminating substandard franchisees, delivering a consistent, high-quality guest experience and boosting marketing and reservation performance. No one wants to allow substandard franchisees to diminish the value of a strong brand.

In addition, I expect fair and honest treatment from my franchisor, plus appreciation and respect. I need a partner who helps me to succeed and a relationship that makes life fun and fruitful. Anything less is not acceptable. So where are the problems? Most hotel franchisee concerns can be grouped into three general categories:

(1) *The fairness of the basic franchise agreement.* The franchise agreement should be a partnership agreement of trust and accountability between the franchisee and the franchisor. The reality is that today's hotel franchise agreements are amazingly one-sided and unfair, heavily-skewed in favor of the franchisor.

This should not be surprising since today's agreements are crafted solely by the franchisor's highly-paid corporate lawyers whose job is to protect the franchisor against any and all contingencies including any possible litigation by the franchisee. Current agreements contain as many rights and as few responsibilities as possible for the franchisor, while just the opposite is true for the franchisee. Depending upon the brand, there is often no negotiation allowed to change the terms and conditions of the agreement. This is not a fair way to deal with potential partners whose investment capital and fees will build the franchisor's brand and create billions of dollars in added value for a successful franchisor.

It seems that the stronger the brand, the more one-sided the franchise agreement tends to be. Marriott's agreement runs to 64 legal pages, Promus' agreement runs to 23 pages, while Choice's agreement is down to 12 pages in fairly straightforward English. The attitude of some of the stronger brands is, "We don't sell franchises, *we grant them*!" This smacks of unnecessary corporate arrogance.

One problem is that under current hotel franchise agreements, hotel franchisors have the unilateral right—without the permission of its franchisee—to sell our franchise organization to anyone they choose, to change brand standards, to impose new fees, to introduce new brands, to invade my marketplace, to extort suppliers, to cut services if needed to boost profit margins and to do just about anything else, all at their sole discretion. That's not a partner-friendly agreement.

The franchisee is required to sign a binding 20-year agreement which can be conveyed to new corporate owners in a merger, sale or consolidation. New owners can arbitrarily change the brand, change the rules or change the fees without my input or consent.

Franchisors prefer a 20-year agreement with no windows or mutual outs. I believe mutual termination windows on the 5th, 10th and 15th anniversaries of the agreement are essential and should be a part of any fair franchise agreement. Few brands or companies have a 20-year useful life without a change in ownership or a dramatic change in direction. In addition, even the best brand names don't always work in some marketplaces. Just as marriage partners don't sign 20-year agreements with no outs, neither should franchisees. Good long-term business relationships are hard to predict, but they seldom last for 20 years, especially in today's world of corporate mergers, acquisitions, global consolidations and *"revolving door"* management.

Franchisor attorneys argue that 5-year windows reduce the shareholder value of the franchisor because a potential buyer of the franchise organization cannot depend on an uninterrupted 20-year stream of royalty income. In fact, this erosion in value has not proven to be true in practice. However, it's an argument I used myself and it is still a favorite of franchisor corporate attorneys.

Franchisees should have a legal right to terminate their hotel franchise agreement without payment of liquidated damages, provided they give the franchisor a 12-month prior written notice before the 5th, 10th or 15th anniversaries. This one-year written notice requirement gives the franchisor adequate time to seek a replacement franchisee and it gives the franchisee time to seek another franchisor, if the relationship is not working.

Many hotel franchisors already include 5-year windows in their standard franchise agreements, allowing franchisees to terminate with a one-year notice. Other franchisors deny the franchisee this right to terminate, but insist on a unilateral right where *they* can terminate the agreement on 5-year anniversaries and require payment of liquidated damages, if a franchisee fails to upgrade to unspecified new standards, promulgated at some future date by the franchisor or his successor. This is not a fair or partner-friendly provision!

A few franchisors like Cendant and U.S. Franchise Systems are introducing performance-based termination provisions, whereby franchisees in good standing can terminate without payment of liquidated damages if the brand is not performing as measured by an occupancy rate greater than 50%.

Why any successful franchisor wants to keep an unhappy franchisee (i.e., customer) in his system is beyond me. Best Western has the right idea; they allow their members (franchisees) to terminate from the system at any time. This imposes a strong franchisor obligation to provide meaningful services that add value. It is one reason why Best Western has enjoyed enormous growth and success.

Promus revolutionized the hotel industry with its gutsy 100% customer satisfaction money-back guarantee. If a guest is not 100% satisfied, his or her money is fully refunded. The fulfillment cost of this guarantee falls 100% on the backs of the franchisees. If the concept is valid, why isn't a *"100% money-back franchisee satisfaction guarantee"* equally appropriate? Promus, or perhaps one of its competitors, should take an emboldened *customer satisfaction* position and be the first franchisor to introduce a *"100% money-back franchisee satisfaction guarantee."*

Another area of *fairness* concerns the amount of liquidated damages paid to the franchisor. Liquidated damages are intended to compensate the franchisor for loss of revenue based on granting an exclusive marketing territory to a franchisee for an unfulfilled time frame. Franchisors contend that they need one, two or three years of liquidated damages if a franchise terminates prematurely because it takes that long to replace the franchisee and the lost revenue stream. In fact, strong franchisors like Marriott, Promus, Holiday or Choice can replace a terminated franchisee in less than a year. The franchisor's argument that they should be paid for the grant of an exclusive geographical marketing territory is negated when the franchisor retains the absolute right to place the same brand, or any of his other brands, in the same marketplace as the existing franchisee. So much for an *"exclusive"* territory!

The truth is that liquidated damages are simply a way for the franchisor to discourage a brand change by the franchisee. The threat of hundreds of thousands of dollars in liquidated damage payments is both frightening and punitive to the franchisee. It makes changing brands nearly impossible and forces the franchisee to become a slave of the franchisor.

Another unfair provision of the franchise agreement involves restrictions on the sale of my hotel. Too often, if I want to sell my hotel, I am precluded from selling or leasing my real estate asset without the written consent of the franchisor under penalty of termination and payment of liquidated damages.

Under one leading chain's franchise agreement, I am prohibited from selling my hotel to any buyer who owns any hotel brand, trade name or chain, or to anyone who exclusively operates or develops competitive hotels. This is outrageous and unfair! Any restrictions placed on the sale of my hotel reduce the value of my investment and inhibit my flexibility.

Some franchisors insist on a *"right of first refusal"* giving the franchisor a right to buy my hotel when a competitive offer is received. What private buyer would offer to buy my hotel when the existing franchisor has a contractual *"right of first refusal"* and could step into the sale process at the last minute before closing? The *"right of first refusal"* is even more unreasonable because most hotel franchisors have separated their real estate business from their franchising, brand and management business which means that the franchise companies no longer buy real estate, making their *"right of first refusal"* meaningless.

I would be willing to accept restrictions on the sale of my hotel real estate assets if the franchisor would be equally willing to accept similar restrictions on the sale of his franchise system. Fat chance that franchisors would give the franchisees a *"right of first refusal"* or accept contractual restrictions on who the franchisor could sell the brand or the franchise system to. The goose and the gander need to get in sync on this one.

Another unfair provision in the franchise agreement concerns the requirement by some franchisors for *personal guarantees* from the owners or officers of the franchisee's company. Franchisor lawyers like to emulate real estate loan officers and require personal guarantees to provide the franchisor with another layer of recourse protection in the event of non-payment of disputed franchise fees.

Financially successful, high net worth people, such as Bill Marriott, or Norm Blake or Curt Carlson would not sign personal guarantees if they were franchisees. Instead of providing personal guarantees, they would cross-collateralize their hotels or sign corporate guarantees.

If hotel owners who have been pre-qualified by franchisors as financially secure can show their franchisors, that personal guarantees were not required for their real estate loans, they should not be required to sign personal guarantees for their franchise agreements. Reason must replace corporate arrogance and trust must replace inflexibility if we are to create a true win-win partnership franchise agreement.

(2) The second general classification of hotel franchisee concerns involves the issues of *impact; encroachment, invasion of territory or area protection.*

This volatile and hotly debated issue deals with the blanket right of the franchisor *"to build, own or franchise any of its current brands, including the same brand or future brands, anywhere it chooses, at its sole discretion, including on sites adjoining or adjacent to the existing franchisee's hotel. The grant of a new franchise in the same territory can be without notice to the existing franchisee."* The agreement may specify that *"the existing franchisee cannot object or seek legal remedy under penalty of termination including a required payment of 3-years of liquidated damages."* These are definitely not partner-friendly provisions!

It matters not whether the new franchisee competes directly with the existing franchisee, whether the franchisor's actions create confusion in the marketplace, or whether the new franchisee adversely affects the performance of the existing franchisee, including a reduction in the value of his real estate asset or potential bankruptcy.

More enlightened franchisors such as Choice Hotels International consult with their franchisees to jointly craft a fairer written impact policy approved by the franchisee advisory board and others define geographic areas of protection. Cendant Corporation negotiates fee abatements for existing franchisees who are unfavorably impacted. A few franchisors commission independent impact studies performed by third-party consultants and resolve conflicts through arbitration. An injured franchisee should be able to terminate without payment of liquidated damages when the arbitrator concludes that the existing franchisee's territory has been unfairly impacted.

Another possible remedy is the inclusion of a *Covenant of Good Faith and Fair Dealing* in a franchise agreement where franchisors, are prohibited from unilaterally taking discretionary actions which are adverse to the franchisee's best interests. Today, a *Covenant of Good Faith and Fair Dealing* is resisted by most franchisors.

All franchisors tell their franchisees, *"Trust me. We wouldn't do anything to hurt our franchisees."* The problem is that mature hotel franchisors with saturated markets are forced to grant new franchises on top of existing franchisees to attain the double-digit earnings growth required by their shareholders and Wall Street analysts. Multi-brand franchisors simply introduce new brands to bypass the impact problem. This allows them to grow in saturated marketplaces.

(3) The third general classification of hotel franchisee concerns revolves around the *growth in preferred vendor programs*. In my opinion, this issue is a ticking time bomb!

Ever since Henry Silverman boasted to Wall Street that Cendant earns $25 to $80 million in added revenue paid annually by hotel product and service suppliers to gain access to Cendant's franchisees, every major hotel chain has made an unseemly grab for vendor cash to painlessly boost bottom-line profits.

Franchisors call their programs "preferred vendor programs" or "strategic partnership programs". They sell the alleged advantage of a greater selection of endorsed products and services at lower prices. The common theme is to use the collective purchasing power of the franchisees to solicit up-front vendor payments that are not shared with the franchisees.

There is a question of legality in forcing vendors to buy access, to gain exclusivity or to attain a preferred marketing position. I call this a *vendor extortion* program. Nevertheless, vendors have been lining up to pay outrageous up-front fees to powerful franchisors for access to their franchisees.

Franchisees understand there is no free lunch. The cost of these programs is a marketing expense to vendors that will ultimately be passed on to the franchisees in the form of an increased cost of goods and services.

Today, preferred vendor revenue goes directly to the franchisor's bottom line. Franchisors argue they have marketing expenses against this income but these amounts are insignificant in comparison to the fee income.

Franchisees should demand at least a 50-50 sharing of preferred vendor revenues, something no franchisor allows today. This is not *"chicken change"* we are talking about; this is reported to be $25 million per year just in the Cendant system alone.

The issue gets even more lucrative when you talk about the possible sale of market data, including the names, addresses and purchase preferences of hundreds of millions of hotel guests. This data, now captured at check-in by the new hotel Property Management Systems, is an invaluable resource for customer database management and marketing. If the data is sold, who owns it? Who is entitled to the proceeds? Should the sale of data collected by franchisees offset the cost of technology, now paid for exclusively by franchisees?

There are many other areas of concern between hotel franchisees and franchisors that need to be resolved through open dialogue and mutual trust. They include:

(1) What is the proper role of the franchisee advisory councils? How much power and control should they exercise?

(2) What is the proper allocation of marketing and reservation funds in multibrand and global franchising companies. Are franchisees entitled to an independent audit of funds and full disclosure?

(3) Do all franchisees pay the same royalty rates? Are there favored franchisees? Can fees be raised unilaterally by the franchisor?

(4) Should franchisee-franchisor disputes be settled by arbitration or litigation? Should disputes be resolved in the franchisee's home state?

(5) What access to information, reports, marketing data, reservation data and other data should franchisees receive?

(6) How can franchisors quickly purge their system of non-performers or bad apples without court challenges and costly litigation?

(7) How do franchisors partner with franchisees to change rules and regulations involving quality standards, required franchisee services, purchasing programs, training, technology upgrades, frequency programs, guest discount programs, customer satisfaction measurements, public relations programs and local marketing programs?

(8) Should a "most favored nations" clause be added to the basic franchise agreement stipulating that if a more favorable right is granted to one franchisee it should apply to all franchisees?

All these issues (and more) need to be addressed and resolved in a spirit of partnership and cooperation. Some franchisors, like Mike Leven at U.S. Franchise Systems, get it. They have flexible and partner-friendly agreements, correctly recognizing that a fairer agreement gives them a competitive advantage.

Other franchisors cling to the outdated autocratic notion that they are entitled to any franchise agreement they want regardless of the unfairness of the terms because prospective franchisees have a free choice to sign or not to sign their agreement. This gun-to-the-head, take-it-or-leave-it approach, doesn't make good business sense if the franchisor really wants a responsible partnership arrangement with integrity and respect on both sides.

Enlightened franchisees are becoming more vocal concerning a perceived need for a fairer franchise agreement that reflects a true partnership relationship. It does not appear that corporate attorneys in the most powerful franchisor companies will become advocates for change. They prefer the status quo, the current master-slave relationship, with its imbalance toward the franchisor.

It would be nice if franchisors could agree to friendly change. Unfortunately, it will probably take the threat of concerted franchisee efforts from their best and most reasonable franchisees to negotiate fairness and redress the current imbalance. The franchisor and the franchisee are joined together at the hip in a mutual enterprise that should not benefit one at the expense of the other.

*"Fairness in Franchising"* is an idea whose time has come. I propose that the presidents of the franchise advisory councils of the major hotel franchisors come together with the presidents of AAHOA, AAFD and the IFA to collectively support the drafting of a model fair franchising hotel agreement. Adequate funding would be

pledged by each council from franchisee dues to retain the best franchisee-friendly attorneys to help draft a universal fair franchise agreement and, if necessary, to hire paid lobbyists to initiate legislative action at the state and federal level to redress the current imbalance and pressure the major franchisors to make needed and meaningful changes.

Franchisors should view this effort not as a threat, but as a coordinated effort by their best concerned franchisees working across brand lines to seek fair franchising legislation if meaningful voluntary change is not forthcoming from the franchisors.

Franchising today is a powerful industry. It has been called the future of American commerce, the ideal way to extend the dream of small business ownership to millions of Americans and entrepreneurs around the globe. It is the preferred business model for entrepreneurs in the 21st century. Fifty cents out of every dollar spent in this country reputedly goes to a franchisee according to the International Franchise Association. By the year 2000, franchisees will generate an estimated $1 trillion in annual revenues. The plight of the small businessperson battling major corporations catches the attention of legislators at both the state and federal level. My hope is that reasonable franchisees and franchisors sitting down together can reduce the current imbalance without government intervention.

To achieve parity, franchisees of the world must unite and speak with a stronger collective voice. We have nothing to lose except our chains by negotiating fairer franchise agreements and better partnership relationships to make rhetoric and reality more closely coincide.

ROBERT C. HAZARD, JR., *Chairman,*
*Creative Hotel Associates,*
*Former Chairman & CEO,*
*Choice Hotels International.*

## FIVE WAYS TO MAKE A GREAT HOTEL FRANCHISOR

BY ROBERT C. HAZARD, JR.

Franchising, which started as a business format only 35 years ago in the United States, is clearly the best hope for entrepreneurs who want to be in business for themselves. It has become the business structure of choice for entrepreneurs around the world. The 663,000 franchised outlets in the US generate almost a trillion dollars in annual sales. Fifty cents out of every dollar spent in the US goes to a franchisee, according to the International Franchise Association. In this country, 62% of all hotel rooms belong to a recognized franchise chain. That share jumps to 75% when seasonal inns and hotels of under 25 rooms are excluded.

Today, franchisees represent 100% of the 5,082 hotels in the Cendant system; 100% of the 4,030 hotels in the Choice system; most of the 2,104 hotels in the Bass Hotels & Resorts system; a growing percentage of the 1,436 hotels in the Marriott system; most of the 1,157 hotels in the Promus system; and most of the 767 hotels in the Radisson system. The entry of Hilton, Sheraton, Westin, Wyndham, Red Roof, Microtel, Baymont, AmeriSuites, Candlewood Suites, Hawthorn Suites, Summerfield Suites, Motel 6, Homestead Village, Homegate, Shoney's and a host of other companies into franchising increases the need for a closer look at how to improve the franchisor-franchisee relationship.

The word *"franchise"* still retains its original French meaning of *"frankness"* or *"fairness"*. Successful franchising requires franchisees and franchisors to come together to see eye to eye, while guaranteeing mutual rights and responsibilities in a spirit of *"partners for profit"*. The rhetoric is always there; the reality doesn't always happen.

What are the five things that make a *great* franchisor?

The *first ingredient* is superior products, superior brands and a superior service package. Stronger brands have consistent, higher-quality products—products that consumers value and need, and products that deliver a measurable competitive advantage. You must also have a franchisor who has a total commitment to quality improvement by upgrading or removing the bottom 10% of the system each year.

Great hotel franchisors provide a recognized and respected brand name, a productive marketing and reservation system that delivers at least 30% of each hotel's occupancy, strong global advertising and marketing programs, a tough quality inspection program, architectural prototype plans, purchasing assistance, training and limited operations support. This is not a business model franchise where cheeseburgers are cooked and served exactly the same way.

In a great hotel franchising system, franchisees and the franchisor share a common bedrock belief that both have the same vital interest in strengthening the brands, rapidly terminating substandard franchisees, delivering a consistent, high-quality guest experience and boosting marketing and reservation performance. Neither wants substandard franchisees to diminish the value of their brands because that depreciates the value of the franchisee's substantial real estate investment.

The great hotel franchisors in the future will numerically rank each of their franchisees on a quality scale from top to bottom, from one to whatever, not only to create competition among franchisees to be number one, but to identify the bottom 10% so they know unconditionally that they must upgrade or be terminated.

The *second ingredient* is the right culture and the right management team. In great franchise systems, franchisors and franchisees are joined at the hip in a mutual enterprise that does not benefit one at the expense of the other. Franchisees and franchisors are like two parts of a zipper. Neither can function independently; both must pull together to succeed.

There is nothing worse than a franchisor management team that doesn't understand its franchisees. In the last few years there has been a rapid turnover of management at many major hotel franchise companies. It takes time for a franchisee advisory council to train a new CEO. Changes in corporate management always bring changes in corporate culture and corporate direction. This can be disruptive to good, solid franchisor-franchisee relationships. It's a tough job for franchisees to teach their franchisor how to be more franchisee-friendly.

Some franchisor management teams think their primary job is to boost their corporate earnings and increase the price of their stock on Wall Street. They don't understand that their first responsibility should be to make their franchisees on Main Street more profitable. They forget that if they service their franchisees exceptionally well, their profits will follow. Franchisee satisfaction is what this business is all about. Increased corporate profits are the report card for a service well-done.

The attitude of some of the stronger franchisors is *"we don't sell franchises—we grant them"*. That smacks of unnecessary corporate arrogance. An equally unfortunate franchisor position is the outdated and autocratic notion that a strong franchisor is entitled to whatever one-sided franchise agreement his lawyers can draft, regardless of the unfairness of the terms, because prospective franchisees have a free choice to sign or not to sign his agreement. This gun-to-the-head, take-it-or-leave-it attitude doesn't make good business sense, if the franchisor really wants a responsible partnership with integrity and respect on both sides.

The biggest tragedy is when trust and integrity between the franchisor and the franchisee begin to break down. Inflexibility replaces reason and mutual trust. Great franchisors have an honest appreciation for their franchisees. They use the *"power of we"* to cement relationships. *We* build trust and pride in our collective accomplishments. *We* inject energy, enthusiasm and excitement into our relationship. *We* have fun. *We* celebrate creativity. *We* put a little zip into life and we try not to take ourselves too seriously.

The *third ingredient* for a great franchisor is an attitude of *"business in the sunshine"*. This means that the franchisor is willing to share all relevant information and operating results with their franchisees in an atmosphere of openness, frank dialogue and mutual trust.

Most franchisors fear giving their franchisees too much information. They think it will give franchisees more power. They are nervous about full disclosure of relevant financial records such as marketing and reservation fund allocations or corporate profit margins on royalties. They forget that their franchisee advisory council has a fiduciary responsibility to ask for full disclosure and an independent audit of both the marketing and reservation funds. To do less would be a dereliction of its duty.

The *fourth ingredient* of a great franchisor is an active, involved, well-funded, respected franchisee advisory council. At Choice it is called the International Operators Council. Marriott and Promus are just getting started with Franchisee Advisory Councils for their brands.

It is important for a great hotel franchisee advisory council to be made up of mostly owners and some general managers who are smart, involved and passionate about working with the franchisor to improve their system. Membership can be elected, but it should be heavily skewed in favor of the best 50% of the franchisees because it is this group that makes or breaks your brand.

Great franchisee advisory councils are led by franchisees who volunteer their time and effort to resolve differences with dignity, respect and fairness in a partnership environment. If necessary, franchisee advisory council leaders should be empowered to add presidential appointments to boost unique skills and professionalism and to weight the council in favor of their best franchisees. Successful busy franchisees often don't want to campaign and run for elections.

The franchisee advisory council must meet regularly with the franchisor's senior management team and stay focused on how both the franchisor and the franchisee can make more money. Franchisees must have easy access to the highest level of management in the franchisor company. Neither franchisees nor franchisors should get involved in petty politics; neither should act solely in their own best interest; neither should vent anger, hostility or frustration because these are non-productive emotions that don't resolve important issues.

Hotel franchisors fear giving up power to an organized franchisee effort. They have a love-hate relationship with their franchisee advisory councils. On the one hand, they love getting input on the potential impact of proposed mandatory programs. They like using the council to endorse improvements in quality standards and guest satisfaction, even when these programs negatively impact franchisee profit margins and reduce operating earnings.

On the other hand, they fear giving up any power or decision-making to a strong franchisee advisory council. Franchisors always emphasize the second word—*"advisory"*—when discussing their franchisee advisory councils. They especially fear strong franchisee advisory councils who are self-funded, where membership dues can be used to hire competent legal counsel, auditors and lobbyists who can represent the franchisees in disputes with the franchisors.

Franchisors prefer to deal with single franchisees rather than a group of franchisees with shared interests. For their part, franchisees must have the courage to come together to claim their most ordinary and basic right—the right to be treated fairly by their franchisors as equal *"partners for profit"*. The issue of what is the proper role and responsibility of the franchisee advisory council is an issue searching for an answer. How much power and control will franchisors surrender to their franchisee advisory councils? That answer is painfully obvious—as little as possible!

The *fifth ingredient* is the need for fairer franchising agreements. It starts with the fees. When hotel franchisees pay their franchisor 9 to 10% of gross revenues they are often paying out 50% of their gross profits. Twenty years ago, hotel franchising fees totaled 5%, half of today's current assessments. The franchisor always takes his cut off the top. He makes money even when the franchisee has a negative cash flow.

Each time the franchisee raises room rates 4 to 5%, the franchisor gets a 4 to 5% raise. The franchisee puts up 100% of the real estate capital investment. He takes all the asset risk; the franchisor takes none. That's a good deal for the franchisor. Even a small company like Creative Hotel Associates, will pay its franchisors over $60 million in franchise fees for our 50 hotels over 20 years. We will also invest over $350 million in real estate assets to build our franchisors' brands. We are good customers who need to be treated with respect.

Established franchisors don't want change. Too often, the stronger the brand, the more one-sided the franchising agreements. This should not be surprising because today's agreements are crafted solely by the franchisors highly-paid corporate attorneys with no input from the franchisees. The current agreements contain as many rights and as few responsibilities as possible for the franchisor, while just the opposite is true for the franchisee. Depending upon the brand, there is often no negotiation allowed to change the terms and conditions of the agreement.

Under current franchisor agreements, franchisors have the unilateral right to sell their brand to anyone they choose, to change brand standards, to impose new fees, to invade the franchisee's territory with the same brand or a sister brand, to extort suppliers and raise the cost of purchasing without sharing of revenues, and to cut services, if profit margins need to be improved to boost stock prices or meet quarterly earnings projections.

In most cases, franchisees are required to sign a binding 20-year franchise agreement that conveys if the franchise system is sold. Few brands or companies have a 20-year life without a change in ownership or a dramatic change in direction, especially in today's world of corporate mergers, global consolidations and revolving-door-management changes. It is essential that franchisors grant five-year windows where either the franchisee or the franchisor can terminate the relationship with a one-year written notice without payment of liquidated damages.

There are many other fair franchising issues that need examination and resolution. The amount of liquidated damages upon termination of agreements; the imposition of a franchisee-friendly 100% customer satisfaction money-back guarantee; the question of exclusive territories and impact; and current franchisor prohibitions on the sale of an individual franchisee hotel, to name a few. Franchisees might be willing to accept restrictions on the sale of their hotel real estate assets, if the franchisor were equally willing to accept restrictions on the sale of his franchise system. The goose and the gander need to get in sync on this one.

So what's the bottom line? Franchisees and franchisors have to work together and get on the same side. They have to enjoy working with each other. There is a strength and a magic in a great franchisee-franchisor partnership. Partnerships are never free of conflict. There will always be disagreements. It is natural for franchisees and franchisors to have differences of opinion; it is not natural or helpful to have a cat fight.

It would be nice if franchisors and franchisees could sit down together and reasonably agree to substantive change. It would be nice if our industry could come together and craft fairer franchise agreements that embrace a true partnership philosophy. Unfortunately, it does not appear that corporate attorneys in the most powerful franchisor companies will become advocates for change. They prefer the status quo with its current imbalance in favor of the franchisor.

There are two paths to help franchisors agree to friendly and positive change.

The first is for their best franchisees to come together to negotiate the fairness issues and redress the current imbalance. *"Fairness in franchising"* is an idea whose time has come. I would propose that the presidents of the strongest franchisee advisory councils in lodging come together with the presidents of AAHOA, ICHMMC, AH&MA and the IFA to collectively support the drafting of a model fair franchising agreement for hotel franchisors. Adequate funding would be pledged by each council from franchisee dues to retain the best franchisee-friendly attorneys as advisors. Individual franchisee councils could then compare their own brand agreement with the model agreement and suggest meaningful changes to their franchisor.

If fairness negotiations are rejected by the major hotel franchise companies, a second and more painful remedy for both would be pursuit of new federal or state legislation to advance needed and meaningful change. This is by far the less desirable solution, but it may be necessary to turn the wheels of justice and fairness to get franchisors to give up some of their preciously protected power.

The plight of the small businessperson battling a major corporation catches the attention of legislators at both the state and federal level. My hope is that reasonable franchisees and franchisors sitting down together can reduce the current imbalance without government intervention, because once the genie of government is let loose from the bottle, no one can predict the outcome. At that point, only the lobbyists and lawyers win for sure.

The *Meineke Discount Muffler* class action lawsuit, where 2,500 present and former Meineke franchisees initiated a lawsuit against the franchisor for mishandling the advertising fund, was an unfortunate adversarial relationship. A jury handed down a $346 million judgment against Meineke which was trebled under North Carolina's unfair trade practices act to $601 million. A judge later reduced the award to $390 million, the largest award in franchising history. Even though the dispute was finally resolved in the courts, it was a tragedy for both sides. The lesson to be learned is that neither franchisee lawsuits nor government intervention are viable solutions, except as a last resort.

To achieve change, franchisees of the world must unite and speak with a stronger collective voice. Franchisees have nothing to lose except their chains by negotiating for fairer franchise agreements and better partnership relationships. It is important to make today's franchising rhetoric and reality more closely coincide.

ROBERT C. HAZARD, JR., *Chairman,*
*Creative Hotel Associates,*
*Former Chairman & CEO,*
*Choice Hotels International.*

## ABOUT THE AUTHOR

Bob Hazard has been involved in franchising for more than 30 years, mostly as a franchisor, but more recently as a multi-unit, multi-brand franchisee of Marriott, Promus and Choice. As CEO of Best Western, he helped Best Western grow from 800 smaller motels to 3,000 inns, hotels and resorts worldwide. During his tenure, Best Western passed Holiday Inns to become the largest franchise hotel company in the world in number of hotels.

In 1980, fourteen members of his team moved with him to Washington, DC to take over a struggling group of 300 older, tired hotels then known as Quality Courts. More than 200 of those original 300 franchisees were terminated for failure to meet quality standards. Hazard's team spent the next 15 years growing Quality Inns (which was renamed to Choice Hotels International) into the second largest franchised hotel company in the world with 3,500 inns, hotels and resorts and 350,000 guest rooms in 42 countries. If you stayed just one night in each Quality, Comfort, Clarion, Sleep, Econo Lodge, Rodeway or MainStay guestrooms, it would take you 959 years to visit each one and by that time you'd be too old to care.

Choice was the first hotel chain to introduce brand segmentation, offering different brands at different price points. It sold new franchises by creating the industry's most efficient and productive marketing and reservation system, by implementing a strict quality assurance program and by treating its franchisees as its partners for profit.

When Hazard retired in 1996, the value of the Choice franchising business, in which he was a part owner, had grown from $15 million to a billion dollars. Not content to retire and clip coupons, Bob and his three long-time partners—Jerry Petitt, Rick Kaden and Steve Mullinger, all former Choice executives—decided to switch hats and become franchisee owners. Today, their franchisee company, Creative Hotel Associates, has built or acquired 10 hotels with another four hotels under development. Their goal is to own and operate 50 hotels in five years.

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LEARNING UNLIMITED
KUMON CENTER,
*Palatine, IL, June 24, 1999.*

Hon. GEORGE W. GEKAS,
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR CONGRESSMAN GEKAS: Because I am unable to afford the travel costs related to a trip to Washington, DC, I request that this letter be used as testimony as part of the June 24, 1999, hearing on the franchise industry. A computer disk containing this letter is enclosed for your use.

I own and operate a Kumon Learning Center franchise in Palatine, Illinois, where I work more than 50 hours per week tutoring children. Yet, I net less than $5.00 per hour. My franchisor has opened numerous other centers near me, takes a 37% royalty, does virtually no advertising, prohibits me from getting involved in any other programs related to education, and tells me there is nothing I can do about any of it. Unfortunately, they are right. Because there are no laws and regulations governing the franchise industry in the United States, I am at the mercy of a unilaterally drawn franchise contract that can be changed at any time without my input.

Please enter this letter into the record of the hearing testimony. If you have any questions or need further information, please contact me, as I would be honored to speak with you or any other member of the committee.

Sincerely,

PATT HEISE, *Director.*

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PREPARED STATEMENT OF PATRICIA & MICHAEL SMITH-BRADLEY, LOS GATOS, CA

Our names are Patricia and Michael Smith-Bradley. We became involved in a franchise system in 1981 when we purchased three Chem Dry carpet and upholstery cleaning franchises. These franchises covered the franchise territories of Mariposa County, CA, San Jose, CA and Morgan Hill/Gilroy, CA. In 1983 we purchased two additional Chem Dry carpet cleaning franchises, one in Campbell/Saratoga and the other in Los Gatos, CA. During the course of the next twelve years we purchased additional franchises in Santa Cruz County, CA, Los Altos/Sunnyvale, CA and a second one in Campbell/Saratoga, CA. Hence, we are the owners of a total of eight Chem Dry franchises. This endeavor has proven to be a very profitable operation for us and our family.

When we purchased the first three franchises in 1981 the franchise license agreements were assignable and "automatically renewable" upon the expiration of each five year term. However, when we purchased the two franchises in 1983 the terms of the franchise license agreement were changed; now upon renewal the agreements were still "automatically renewable" but also had the requirement that we sign a "then current franchise license agreement" upon expiration of the five year term. How can a contract be "automatically renewable" and yet one has to sign a totally different contract?

The remaining three franchise license agreements required us to sign a current franchise license agreement upon the expiration of a five year term. As with all of the prior contracts that we entered into with our franchisor we signed these contracts with the understanding that the franchisor, Harris Research, Inc., would abide by the standard of "good faith" and "fair dealing" that is expected in any contractual relationship between two parties. We believed that the franchisor would use these standards five years later when they required us to sign renewal franchise license agreements upon expiration of the five year term. How wrong we were!

About five years ago, our franchisor, Harris Research, Inc., which was owned 100% by Robert Harris, the developer of the "carbonated carpet cleaner", decided to sell 80% of his ownership interest in Harris Research, Inc. to Summit Partners, an investment firm. Shortly thereafter the franchise license agreements were unilaterally changed to include several onerous provisions in them. We, the franchisees, were not given the opportunity to exercise our right to negotiate any changes to the franchise license agreement. In a letter dated December 13, 1994 (scanned copy attached) from Harris Research, Inc. that accompanied a renewal package for our Los Altos/Sunnyvale franchise the following sentence appeared: "You may wish to carefully compare the enclosed Agreement with that you now have to determine any changes. You may also wish to discuss this matter with your attorney. It is important to note that because of the large number of franchises now in force, the changing of any provisions of the enclosed renewal Franchise License Agreements to reflect your personal desires is non-negotiable." This practice has been in effect for years. Why is this practice acceptable in a franchisor/franchisee relationship but not in other contract relationships in other small businesses?

We have attached a scanned copy of one of our 1981 franchise license agreements with Harris Research, Inc. and a scanned copy of a 1998 franchise license agreement with Harris Research, Inc. for your review.

To save you some time, we would like to summarize some of the major, unilateral, onerous provisions that are included in the 1998 franchise license agreement.

1. The mandatory purchase of additional, unproven capital equipment to be used in the carpet and upholstery cleaning franchise. The cost of this equipment is approximately $6,000; it is known as the "Velda" and applies carpet cleaning solution to the carpet.

2. The changing of the carpet cleaning method to be used in our franchised business from a "carbonated carpet cleaner" to a "carbonating carpet cleaner"; in essence the change to a "steam cleaning" method after almost twenty years of promoting the Chem Dry method of cleaning carpets as being a "unique" method that dries in one hour or less.

3. Franchisees are required to purchase $2,000 worth of solutions from the franchisor each year versus $1,000 per year in prior agreements.

4. By signing the 1998 agreements, the franchisor has "power of attorney" over the franchisee's telephone numbers and customer lists.

5. Franchisee is required to submit a "control report signed and verified by Franchisee accurately reflecting the gross and net revenues of Franchisee's Chem Dry business for the preceding specified time period and copies of all customer invoices during such time period." We pay fixed franchise fees on a monthly basis so why does the franchisor need this information?

6. "Franchisee agrees to purchase or lease one or more vans suitable for the purpose of transporting various equipment, supplies and materials needed to operate a Chem Dry business and which otherwise meets HRI's specifications." Some franchisees have operations which involve ten or more vehicles; some of these vehicles are pick up trucks with camper shells. With this new requirement a larger franchise operation such as ours would be required to replace these trucks with the purchase of vans. This could potentially mean an investment of $200,000 to a larger operation.

7. The conditions for approval of transfer have been made twelve fold.

8. The franchisee has to notify the franchisor if they want a successor franchise.

9. Upon the granting of a successor franchise by HRI, the franchisee must execute a general release, "in form satisfactory to HRI, of any and all claims against each other and their respective affiliates, officers, directors, employees and agents. Failure by Franchisee to sign such agreements and releases within 90 days after delivery thereof to Franchisee shall be deemed an election by Franchisee not to acquire a successor franchise." A copy of the release form is attached for your review.

10. The conditions for termination of a franchise are sixteen fold and the manner in which they can terminate a franchise are much easier for them to enforce.

11. The covenant not to compete is broadened to include "the members of his or her and their immediate families". The "Competitive Business" applies to those businesses which are located "within (1) Franchisee's Franchised Area, (2) ten (10) miles of the boundary of Franchisee's franchised area (3) the franchised area of any Chem Dry business or (4) ten (10) miles of the boundary of the franchised area of any other Chem Dry business.

12. "All controversies, disputes or claims" between HRI and the franchisee arising out of the agreement must be submitted to arbitration in Salt Lake City, Utah office of the American Arbitration Association. It doesn't matter what state the franchisee is operating their franchise business in; the franchisee must travel to the franchisors' state. In essence, the protections of law that their state of residence would entitle them to are stripped from the franchisee. The additional costs of traveling to the franchisors' state is an additional burden to the franchisee.

13. The Agreement and the franchise is governed by the laws of the state of Utah. Why should a taxpayer in California be forced to be governed by the laws of the State of Utah?

14. "Franchisee agrees that HRI may institute any action against franchisee (which is not required to be arbitrated hereunder) in any state or federal court of jurisdiction in the State of Utah and Franchisee irrevocably submits to the jurisdiction of such courts and waives any objection he or she may have to either the jurisdiction or venue of such court." Again, why should a California franchisee such as us be forced to be bound by the court system of Utah?

15. The franchisee cannot seek punitive damages.

16. The right to trial by jury is waived by the franchisee. Isn't this one of our rights as an American citizen?

17. The incorporation of the monthly newsletter as part of the contract. In other words, if HRI prints a new requirement in the newsletter it becomes part of the franchise license agreement and a means whereby HRI can terminate a franchise if the franchisee does not abide by the new requirement.

18. Under the terms of the 1998 franchise license agreement, "It is understood and agreed by the parties hereto that this agreement does not create a fiduciary relationship between them". Why not?

I have not listed all of the changes to the contracts; only some of the major ones. The agreements that we are being "forced to sign" upon renewal are drastically different from those we originally signed when we purchased the franchises. We cannot negotiate the contract. If we want to continue operating the profitable businesses that we have developed through twenty years of hard work we have to sign the agreements. If we don't sign the agreements we must "walk away" from our business of twenty years or try to sell it to a party who is willing to "lease" a business for a purchase price of over a million dollars. Who is foolish enough to do that? We don't know of any other small business owner who is forced to "walk away" from a business after twenty years of hard work leaving the goodwill to another party without compensation. Even if a Chem Dry franchisee does decide to "walk away" from his/her franchise, how will they provide for their family since they cannot work as a carpet cleaner for three years. How is it that a franchisor can continue to compete but the franchisee cannot?

We believe that franchisees have become the "indentured servants" of the modern day "lords". Is it not time for the "lords" or franchisors to become accountable for their actions? Franchisees are asking that the franchisor/franchisee relationship as detailed in the franchise license agreements become parties to a "good faith" and "fair dealing" policy just as other parties to any other type of contract are assured when they sign a contract.

Because we do not believe that the 1998 franchise license agreements have the elements of "good faith" and "fair dealing" in them we have challenged them in the court system. This endeavor will probably cost us thousands of dollars in attorney fees. If a franchisee of twenty years does not agree with the terms of the renewal agreement should they have the right to "walk away" from the franchisor without incurring severe hardship on themselves and their families?

Should they not have the right to continue to operate their small business without the use of the "marks"? If we had signed a "regular" contract twenty years ago we wouldn't have been subject to accepting these major, unilateral changes to the contract. As a franchisee, we do have to accept these major, unilateral changes without the benefit of negotiation?

Let me clarify a couple of points. When we purchased three of our franchises we spent thousands of dollars to purchase the goodwill of existing franchise operations that had been in business for a few years. We have spent millions of dollars over the past twenty years to promote our businesses. Harris Research is not like a fast food franchisor who spends millions of dollars on promoting the "Mark"; in our case Harris Research, Inc. didn't do national advertising to benefit the sales of their franchisees. Now, the new owners of Harris Research, Inc. want to lay claim to the goodwill created by our efforts. Is this fair?

I want to thank you for the opportunity to submit this testimony to you. We sincerely hope that this Committee will make franchisors "accountable" for their actions.

EXHIBIT F

HARRIS RESEARCH INC.
8131 Belvedere Avenue
Sacramento, California
95826

# Franchise License Agreement

This Agreement made and entered into this 14th day of September, 19 81 by and between HARRIS RESEARCH, INC., a California Corporation, hereinafter referred to as "FRANCHISOR", and Mike Bradley & Patricia Smith Bradley, whose address is 5120 Campbell Ave. - #112, hereinafter referred to as "FRANCHISEE", doing business as ( ) a ________________ corporation, (X) a partnership, ( ) a sole proprietorship for the purpose of granting to FRANCHISEE a non-exclusive franchise license under the terms and conditions as hereinafter contained.

I. AREA FRANCHISED. FRANCHISOR hereby grants to FRANCHISEE the non-exclusive right to operate and conduct a franchised CHEM-DRY carpet cleaning business in the following described area:

* Mariposa, County California *

A. FRANCHISOR agrees to grant not more than one franchise per every sixty thousand (60,000) population in the franchised area which area also has been determined by FRANCHISOR based on population, population density, geographical terrain and market potential.

B. FRANCHISEE agrees to operate or conduct its business from a single location within the Franchised Area from which it may operate as many crews, teams, sales forces and vehicles as is desired. All personnel operating under the franchise shall be under the direct control and supervision of FRANCHISEE and be using FRANCHISEE'S business name. FRANCHISEE shall not expand its operations to more than one location within the Franchised Area without the expressed written consent of FRANCHISOR who shall take into consideration the effect such expansion may have on other franchisees within the Franchised Area. Any permission to expand operations to more than one location within the Franchised Area will be upon such terms and conditions as are mutually agreeable to both FRANCHISOR and FRANCHISEE.

C. FRANCHISEE agrees to advertise and solicit business in the Franchised Area only. FRANCHISEE may enter other areas by referral but only in those instances where the referred customer makes first contact with FRANCHISEE.

II. SERVICES FRANCHISED: FRANCHISOR hereby grants to FRANCHISEE the right to conduct a carpet cleaning and maintenance business within the Franchised Area using FRANCHISOR'S CHEM-DRY cleaning chemicals, equipment, methods, supplies, advertising and business services.

III. TERM AND RENEWAL: The term of this Agreement shall begin with the execution date hereof and shall continue for a period of five (5) years unless sooner terminated under any of the termination provisions contained herein. Following the initial five (5) year period, this Agreement shall be automatically renewed for additional consecutive five (5) year periods on subsequent five (5) year anniversary dates without any renewal fees being paid by FRANCHISEE.

IV. USE OF TRADEMARKS, SERVICEMARKS, TRADE NAMES, LOGOS AND PROMOTIONAL MATERIALS: FRANCHISOR has adopted the name CHEM-DRY used alone or in design combinations as a logo, servicemark, trademark and tradename with which to identify services and materials provided to Franchisees by FRANCHISOR which mark Franchisees are required to use to advertise and conduct the services carried out under the Franchise Agreement. FRANCHISOR grants to FRANCHISEE the non-exclusive right to use the CHEM-DRY name which FRANCHISEE agrees to use only in connection with the Franchised Services. Automobiles, trucks, uniforms, advertising materials, invoices and equipment used in conducting the Franchised Services shall bear the CHEM-DRY name. FRANCHISOR may from time to time, develop other trademarks, trade names, servicemarks, logos and promotional materials, and grants to FRANCHISEE the non-exclusive right to use such mark, names and materials when released by FRANCHISOR to all Franchisees. Provided however, FRANCHISEE shall not be required to use more than one name, mark or design to identify the Franchised Services at any one time. In the event any name, mark or symbol authorized for use by FRANCHISOR is determined to infringe any name, mark or design of a third party or FRANCHISOR is enjoined from using such name, mark or symbol, FRANCHISOR may require Franchisees to carry out Franchised Services under a different name, mark or symbol. FRANCHISEE agrees to use only names, marks, symbols or promotional materials which have been approved in writing by FRANCHISOR when advertising, promoting or carrying out the Franchised Services.

V. OWNERSHIP IN PROPRIETARY PRODUCTS AND PROCESSES, PATENTS, TRADEMARKS, TRADE NAMES, SERVICE MARKS, LOGOS, COPYRIGHTS AND PROMOTIONAL MATERIALS: FRANCHISOR has spent substantial time and sums in developing chemicals, processes and equipment to be used in carrying out the Franchised Services and in creating names, marks, symbols and promotional materials and considers all such developments and creations to be of a proprietary nature, some or all or which may be or will be subject to protection under state and federal laws. FRANCHISEE agrees that all such developments and creations are the exclusive property of FRANCHISOR and that any right or license granted by FRANCHISOR thereon is on a non-exclusive basis only and will cease to exist upon termination of this Agreement for any reason.

A. Because the reputation and commercial success of FRANCHISOR'S and FRANCHISEE'S business operations under this Agreement depend greatly upon FRANCHISEE'S proper use and application of designated cleaning chemicals and the image created by FRANCHISEE in promoting and carrying out the Franchised Services, FRANCHISEE agrees to use only equipment, chemicals, supplies and promotional material which have either been obtained from or approved in writing by FRANCHISOR. FRANCHISEE also agrees to allow inspection of its premises by FRANCHISOR at all reasonable times and to allow FRANCHISOR to inspect the quality of work done by FRANCHISEE. Failure to use authorized equipment, supplies and promotional material or not to allow inspections shall be considered a material breach of this Agreement. If upon inspection, FRANCHISOR finds that the quality of work done by FRANCHISEE is substandard, FRANCHISOR may require FRANCHISEE, at its own expense, to take additional training. Failure of FRANCHISEE to take additional training will also be a material breach of this Agreement.

B. In order to obtain maximum results from promotional materials and to maintain the integrity of FRANCHISOR'S names, marks and symbols, FRANCHISEE shall not use promotional materials of any kinds that have not been supplied by or approved in writing by FRANCHISOR. FRANCHISOR shall supply such promotional materials as it develops or obtains to FRANCHISEE as inexpensively as possible. If FRANCHISEE develops or obtains any promotional materials from a source other than FRANCHISOR, such materials shall first be submitted to FRANCHISOR for written approval. If approved, FRANCHISOR shall have the right to duplicate and distribute such materials to all Franchisees.

C. New ideas or inventions when made or obtained by FRANCHISOR will be made available to FRANCHISEE at FRANCHISOR'S sole discretion.

D. Upon termination of this Agreement for any cause, FRANCHISEE shall immediately cease using any and all promotional materials containing names, marks and symbols belonging to FRANCHISOR and to promptly remove any such names, marks or symbols placed upon vehicles, uniforms, signs or on any other places.

~~VI. PAYMENTS: The purchase price for a single franchise is Four Thousand Six Hundred Dollars ($4,600) and the purchase price for one advertising, chemical and equipment package is Two Thousand Three Hundred Dollars ($2,300) both of which must be purchased before a franchise can become operative. Upon signing this Agreement, FRANCHISEE agrees to pay to FRANCHISOR the sum of Four Thousand Three Hundred Dollars ($4,300) and to pay to FRANCHISOR on the tenth (10th) day of each succeeding month for twenty-four (24) consecutive months the sum of One Hundred Dollars ($100). Upon payment by FRANCHISEE to FRANCHISOR of Six Thousand Nine Hundred Dollars ($6,900) and beginning with the month thereafter FRANCHISEE will pay to FRANCHISOR on or before the tenth (10th) day of each month the prevailing franchise fee. This sum shall be subject to change not more than once each calendar year which change shall use as a guide the change in cost of living as determined by the U.S. Government cost of living indices.~~

SEE amendment

A. After purchase of the first advertising, chemical and equipment package FRANCHISEE agrees to purchase all required materials and equipment from FRANCHISOR at the then current list price, less any discounts which may be allowed, and to pay for all purchases no later than thirty (30) days after the date of invoicing.

VII. ACCOUNTING AND RECORD KEEPING: FRANCHISOR shall provide FRANCHISEE with a complete bookkeeping system and training that will enable FRANCHISEE to record income and expenses, calculate taxes and determine profitability. FRANCHISEE agrees to promptly and accurately record all transactions relating to or arising out of this Agreement and hereby authorizes FRANCHISOR or its delegated representative to examine all bookkeeping records arising out of this Agreement at all reasonable times, and to make copies or abstracts from such records. FRANCHISEE further agrees to keep all such records available for a period of five (5) years following the year for which they were kept. Termination of this Agreement shall not alter FRANCHISEE'S obligation to retain records for said five (5) year period.

VIII. TRAINING: Prior to FRANCHISEE'S contracting to provide Franchised Services, FRANCHISOR agrees to provide FRANCHISEE with a *minimum of two [2] days training on how to [1] mix and apply chemicals and use equipment in cleaning carpets for customers under normal working conditions, [2] compute estimates, [3] keep books, [4] solicit and maintain business, [5] replace inventory* and otherwise enter into and conduct a carpet cleaning business using the CHEM-DRY system. FRANCHISEE will receive a Two Hundred ($200.00) Dollar reimbursement from FRANCHISOR upon completion of the initial training to be applied toward travel and living expenses during the training period. FRANCHISEE may be required to take additional training under the provisions of Paragraph V.A. FRANCHISEE may from time to time, obtain additional training at a location to be designated by FRANCHISOR. There will be no charges for additional training except travel and living expenses incurred by FRANCHISEE.

IX. PRICING: FRANCHISEE shall be free to set and determine its own pricing structure for Franchised Services sold and rendered under the terms of this Agreement. FRANCHISEE may request suggested pricing from FRANCHISOR but all prices charged shall be solely at the discretion of FRANCHISEE.

X. INDEPENDENT CONTRACTOR: It is expressly understood and agreed by and between FRANCHISOR and FRANCHISEE that FRANCHISEE will at all times, act as and shall be an INDEPENDENT CONTRACTOR. FRANCHISEE agrees that it will not at any time, directly or indirectly, hold itself out as an agent or employee of FRANCHISOR, or make any commitment, or incur any liability on behalf of FRANCHISOR without FRANCHISOR'S expressed written consent. FRANCHISEE shall be fully responsible for any damage, loss, or other claims arising out of the business conducted by itself or its employees, agents, or representatives, and shall hold harmless, and defend FRANCHISOR therefrom.

XI. COVENANT NOT TO COMPETE: As long as this Agreement is in force and for a period of three (3) years following its termination, for any reason, FRANCHISEE and its principals agree not to engage in or have any financial interest in, either as officer, agent, employee, director, stockholder, owner, or partner, or in any other capacity, or in any business, or in any area, which performs any carpet cleaning or other service conducted by FRANCHISOR or its Franchisees under the terms and conditions of this Agreement, within the Franchised Area or within thirty (30) miles of any boundary of the Franchised Area. FRANCHISEE may hold for investment purposes, up to five percent (5%) of the outstanding stock of any competitive corporation whose stock or securities are publicly held or traded.

XII. FRANCHISEE CONVENANTS: In consideration of the Franchise License granted herein, FRANCHISEE agrees and convenants as follows:

A. To use only cleaning chemicals, supplies, equipment, methods and business forms supplied by and purchased from FRANCHISOR or approved by FRANCHISOR in writing prior to their use.

B. To hold itself solely responsible for the quality and results of the Franchised Services performed under this Agreement maintaining a continuous responsibility with respect to such services performed even after the termination of this Agreement.

C. To use the CHEM-DRY name when soliciting or carrying out Franchised Services, and to display the CHEM-DRY, or other authorized, name, mark or symbol, on all vehicles, uniforms and equipment used in carrying out Franchised Services and to maintain neat and clean uniforms for use of all personnel associated with directly soliciting or carrying out Franchised Services.

D. To use only advertising or promotional materials, including telephone listings, which have been obtained from FRANCHISOR or have been approved by FRANCHISOR in writing.

E. To allow FRANCHISOR to use FRANCHISEE'S name or picture of FRANCHISEE including employees thereof at any time during this Agreement for the purpose of any publication, brochure, or advertisement.

F. To pay for all equipment and supplies purchased from FRANCHISOR within the time allowed by this Agreement and to make any reports when requested which are related to this Agreement.

G. To make all payments due FRANCHISOR within the time allowed.

H. FRANCHISEE agrees that if his business telephone is disconnected and no new number is installed, such disconnection shall be considered to be a material breach of this Agreement.

I. If two or more Franchisees are working with the same customer, whether Insurance Adjuster, Retailer, or whatever, FRANCHISEE agrees to abide by a territorial working agreement prepared by FRANCHISOR at that time.

*J. That even if FRANCHISEE is not working directly in the franchised CHEM-DRY business, FRANCHISEE will be responsible for the successful operation of the Franchised business and will be directly responsible to FRANCHISOR under the terms and conditions of this agreement.*

XIII. FRANCHISOR COVENANTS:

A. *Prior to FRANCHISEE'S beginning operations, FRANCHISOR shall be obligated to have [1] designated the Franchised Area, [2] provided the initial training and orientation, [3] provided FRANCHISEE with a starting inventory of chemicals, supplies and equipment.*

B. FRANCHISOR agrees to make additional training in carpet cleaning and business operation available to FRANCHISEE *after business operations have begun* and at mutually agreeable times when requested by FRANCHISEE *in writing.* Such training will be at FRANCHISOR'S place of business in Sacramento, California, unless otherwise designated by FRANCHISOR at no charge to FRANCHISEE except travel and living expenses during training.

C. *After FRANCHISEE has begun operations, FRANCHISOR shall be obligated to [1] consult with FRANCHISEE by telephone, at FRANCHISEE'S expense, and answer questions or make suggestions regarding operation of FRANCHISEE'S business [2] hold seminars twice a year for all Franchisees, free of charge [except for travel and living expenses] [3] provide advertising materials as they become available and [4] promptly fill all orders for chemicals, supplies and equipment, provided FRANCHISEE is current in his obligations to FRANCHISOR.*

D. FRANCHISOR agrees to continually upgrade and improve equipment, cleaning chemicals and supplies, advertising, training manuals, etc., at FRANCHISOR'S discretion for the mutual benefit of FRANCHISOR and FRANCHISEE.

E. Suggestions which will be of benefit to FRANCHISOR and/or FRANCHISEE are solicited from all Franchisees. Each suggestion or idea will be considered and, if found beneficial, be made available to all Franchisees.

XIV. RESALE OF FRANCHISE: FRANCHISEE shall have the right to resell all rights emanating from this Agreement including the right to perform the Franchised Services in the Franchised Area in addition to selling equipment, cleaning chemicals, supplies and other inventory, customer lists, goodwill and telephone to any person or entity of its own choosing at any time, and upon any terms and conditions it may deem advisable, subject to the following limitations:

A. The prospective buyer shall execute a current Franchise License Agreement with FRANCHISOR prior to the sale, or FRANCHISOR may transfer the old Franchise License Agreement updating it to the same terms and conditions as the current Franchise License Agreement.

B. The Buy and Sell or Purchase Agreement between FRANCHISEE and Buyer shall provide:

1. That the agreement shall be submitted to to FRANCHISOR for approval which approval will not be unreasonably withheld.

2. That FRANCHISEE Covenants not to Compete with Buyer, either as an individual or an officer, employee, investor or in any other capacity, in a corporation or other entity, which engages in the business covered by this Agreement, for a period of three (3) years within the Franchised Area covered by this Agreement, or within thirty (30) miles of any boundary of the Franchised Area.

3. A dollar breakdown of the sale price allocated to Goodwill, Covenant Not to Compete, Vehicles, Cleaning Equipment, Cleaning Supplies and Office Equipment and Supplies.

C. FRANCHISOR shall be paid a transfer and training fee for Franchise resales of Three Hundred ($300.00) Dollars which shall reimburse FRANCHISOR for providing training and a new bookkeeping system to Buyer.

D. FRANCHISOR shall be given thirty (30) days in which to purchase the Franchise being sold for the same price and upon the same terms and conditions included in the proposed Buy and Sell or Purchase agreement.

E. FRANCHISEE agrees that it will not execute any sale of its business except under the provisions of this Agreement, and that any purported sale or assignment not in conformity herewith shall be null and void and constitute a material breach of this Agreement and be grounds for immediate termination of this Agreement at the discretion of FRANCHISOR.

F. *Upon the death or adjudicated incapacity of FRANCHISEE or within six [6] months thereafter FRANCHISOR shall have the right, but not the duty, to repurchase the Franchise at a price to be determined by an independent appraiser selected by both FRANCHISOR and FRANCHISEE'S representatives and upon such terms and conditions as may be mutually agreeable to both parties.*

XV. TERMINATION: If FRANCHISEE materially breaches this Agreement or fails to make any payment, including accounts payable, when due, FRANCHISEE must be given thirty (30) days written notice to correct the breach or make payment to FRANCHISOR. If the breach is not corrected to the satisfaction of FRANCHISOR or if payment is not made within said thirty (30) day period FRANCHISOR may, at its option, immediately terminate this Agreement. FRANCHISEE may voluntarily terminate this Agreement by giving FRANCHISOR at least ninety (90) days written notice of its intent to terminate. This Agreement may be terminated at any time by the mutual consent of both FRANCHISOR and FRANCHISEE.

A. A material breach of this Agreement shall be considered to have occurred upon the happening of any one of the following events.

1. Failure of FRANCHISEE to meet or comply with quality control standards set by FRANCHISOR.

2. Bankruptcy or insolvency of FRANCHISEE.

3. A final court judgement is made against FRANCHISEE which remains unsatisfied for thirty (30) days.

4. Execution is levied against FRANCHISEE'S property or business carried out under this Agreement.

5. Suit is filed against FRANCHISEE to foreclose any lien or mortgage, or garnishment is levied and not dismissed within a thirty (30) day period.

6. FRANCHISEE or a principal thereof is convicted of any law or ordinance providing for criminal punishment.

B. Upon termination of this Agreement for any reason, FRANCHISEE agrees to immediately sign all necessary documents required by the Telephone Company for the purpose of transferring FRANCHISEE'S telephone service, listings and advertising to FRANCHISOR.

C. In the event of termination, if FRANCHISEE continues to use the CHEM-DRY name or any other of FRANCHISOR'S names, marks, or symbols, for more than ten (10) days, or does not render an accounting, or in any other way damages FRANCHISOR, or if any competition by FRANCHISEE or a principal thereof is evident in the area wherein FRANCHISEE and its principals have agreed not to compete in Paragraph XI, then FRANCHISEE agrees to pay to FRANCHISOR the sum of Five Thousand Dollars ($5,000.00) as liquidated damages and not as a penalty, in addition to any other rights and remedies available to FRANCHISOR. This amount is mutually agreed to be an equitable settlement should any competition or other damage be evident, and is established in lieu of ascertaining a specific damage claim.

XVI. CONSTRUCTION, MODIFICATION AND ENFORCEMENT: The provisions of this Agreement shall be construed according to the laws of the State of California. This Agreement contains the entire understanding of the parties hereto, and is acknowledged by both parties that, except as expressly provided in this Agreement and the Prospectus relating thereto, there are no representations, warranties, or other Agreements expressed or implied in any way relating to the provisions hereof. This Agreement when fully executed shall supercede all prior and existing Agreements between the parties having to do with the subject matter of this Agreement. In the event of a breach of this Agreement, the prevailing party shall be entitled to reasonable fees, costs and expenses incurred by him in enforcing the provisions of this Agreement or securing damages for its breach, including, but not limited to, reasonable attorney's fees, and court costs.

XVII. NOTICE: By signing this Franchise License Agreement FRANCHISEE certifies that it has received and reviewed the Uniform Offering Circular, this Franchise License Agreement, the Franchise Roster and the Chemicals, Advertising and Equipment List, at least ten (10) days prior to signing this Agreement and prior to paying any monies.

XVIII. In this Agreement, the neuter pronoun "it" has been used to refer to the FRANCHISEE. Where appropriate, this terminology is considered to also include both masculine and feminine genders.

XIX. If any provision of this Franchise License Agreement is found invalid, both parties agree that all other provisions shall remain in full force and effect.

XX. FRANCHISEE and its signators to this Agreement agree to abide by all terms and conditions contained herein as individuals as well as officers or principals if incorporated.

**FRANCHISOR:**

**HARRIS RESEARCH INCORPORATED**

**Robert D. Harris - President**

**FRANCHISEE(S):**

| Individually and Personally | Corporate Principal | Title |
|---|---|---|
| XX | | |

| Individually and Personally | Corporate Principal | Title |
|---|---|---|
| | | Owner |

| Individually and Personally | Corporate Principal | Title |
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| Individually and Personally | Corporate Principal | Title |
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HARRIS RESEARCH, INC.,
*Logan, UT, December 13, 1994.*

CHEM-DRY OF LOS ALTOS/SUNNYVALE,
*Los Gatos, CA.*

DEAR MR. & MRS. BRADLEY: We hope all is going well with you and your Chem-Dry Franchise. As you know, the Franchise License Agreement contains a clause pertaining to the Term and Renewal of the Agreement. Since the Agreement now in force with Harris Research, Inc. will expire on July 12, 1995 we are now giving you notice of our intent to allow renewal of your Chem-Dry franchise for another five (5) year term, provided you sign the enclosed current Franchise License Agreements and return them to our office for processing by June 12, 1995 . By returning the Agreements expediently, there is no chance that your franchise will be terminated for failure to renew the Agreements before the expiration date.

This notice is being provided as required by the California Franchise Investment Statutes. Under Sections 20025 and 20026 of the California Franchise Investment Law, you must be given at least One Hundred Eighty (180) days notice of our intent not to renew your Franchise Agreement if any of the terms contained in the renewal Franchise License Agreement have been changed from those of the Agreement now in force.

Each year, minor changes are made to the Franchise License Agreement to meet current conditions. The law realized that such changes are inevitable to improve Franchisor-Frarchisee relations, and to reflect changing conditions and situations not originally anticipated. As the number of franchises increases, we find franchisees making requests we haven't previously considered or made provisions for. To cover these, we find that it becomes necessary to make minor changes in the Franchise License Agreement. However, these changes are provided for under the law as long as all franchisees are offered the same revised terms. Harris Research, Inc. does not discriminate between franchisees, and offers all renewals on the same basis. There may be minor changes from state to state to comply with specific state laws. Other than that, all Agreements contain the same terms.

You may wish to carefully compare the enclosed Agreement with that you now have to determine any changes. You may also wish to discuss this matter with your attorney. It is important to note that because of the large number of franchises now in force, the changing of any provisions of the enclosed renewal Franchise License Agreements to reflect your personal desires is non-negotiable,

If there are any errors or changes in the Agreements, please send a separate letter calling these to the attention of our legal department for consideration at the next revision.

To complete the enclosed paperwork, please follow ALL instructions listed on the accompanying green instruction sheet. We look forward to receiving both executed copies of the Franchise License Agreement and all other necessary information/paper-work by *June 12, 1995.*

We look forward to your continued participation in the Chem-Dry franchise system. If you have any questions, please contact me in the Franchise License Department Please note, certified mail sent to the last known address is considered sufficient attempt to locate a franchisee.

MS. KERI WITBECK, *Franchise License Department.*

HARRIS RESEARCH, INC.—FRANCHISE AGREEMENT

THIS AGREEMENT is made and entered into this ________ day of 19-____ (the "Agreement Date"), by and between HARRIS RESEARCH, INC., a Utah corporation, with its principal office at 1530 North 1000 West, Logan, Utah 84321 ("HRI") and ________________________________________, whose principal address is ________________________________________ ("FRANCHISEE").

1. PREAMBLES AND GRANT OF FRANCHISE.

*A. PREAMBLES.*

HRI has designed and developed a method for establishing, operating and performing carpet and upholstery/drapery cleaning, spotting and protective services using HRI's CHEM–DRY specifications, standards, operating procedures, supplies and specialized equipment, all of which may be improved, further developed or otherwise modified from time to time (the "CHEM–DRY Business"). HRI owns all rights to, interest in and goodwill of, and uses, promotes and licenses certain trade names, trademarks and service marks and other commercial symbols, including the service mark, trademark and trade name "CHEM-DRY" (the "Marks"). HRI has designed and developed, and owns all rights to, certain specialized equipment and products for use in the CHEM-DRY Business.

FRANCHISEE acknowledges that he or she has read this Agreement and HRI's Uniform Franchising Offering Circular and that he or she understands and accepts the terms, conditions and covenants contained in this Agreement as being reasonably necessary to maintain HRI's high standards of quality and service. FRANCHISEE acknowledges that he or she has conducted an independent investigation of the business contemplated by this Agreement and recognizes that it involves business risks and that the success of the venture is largely dependent upon the business abilities of FRANCHISEE. FRANCHISEE acknowledges and agrees that HRI's officers, directors, employees and agents act only in a representative and not in a personal capacity in their dealings with FRANCHISEE. FRANCHISEE further acknowledges that he or she has not received or relied upon, any warranty or guaranty, express or implied, as to the potential revenues, profits or success of the franchise or policies made by HRI or its officers, directors, employees or agents that are contrary to the statements made in HRI's Uniform Franchising Offering Circular. FRANCHISEE further represents to HRI, as an inducement to its entry into this Agreement, that FRANCHISEE has made no misrepresentations in obtaining the franchise.

*B. GRANT OF FRANCHISE.*

FRANCHISEE has applied for a franchise to own and operate a CHEM-DRY Business and such application has been approved by HRI in reliance upon all of the representations made therein. Subject to the provisions of this Agreement, HRI hereby grants to FRANCHISEE a non-exclusive franchise (the "Franchise') to operate a CHEM-DRY Business in the Franchised Area (as further described herein) and to use the Marks in the operation thereof for a term of five (5) years commencipg on the Agreement Date. FRANCHISEE rbust offer and perform carpet cleaning, spotting and protecting services, including removing red stains, treating pet urine odor on carpets and imparting stain resistance to carpet fibers. FRANCHISEE also may offer and perform upholstery and drapery cleaning, spotting and protecting services or other approved services which may require certification by successful completion of additional training and/or purchase of additional equipment and cleaning solutions. HRI reserves the right to approve additional services from time to time in its sole discretion and require Franchisees who elect to offer and perform such services to be cerfified by successful completion of an additional training and/or the purchase of additional equipment and cleaning solutions. FRANCHISEE agrees to commence the conduct of his or her CHEMDRY Business within sixty (60) days of the Agreement Date. Termination or expiration of this Agreement shall constitute a termination or expiration of the Franchise

*FRANCHISEE agrees to conduct his or her CHEM-DRY Business within the following area:— —*

Such area shall constitute FRANCHISEE's non-exclusive franchised area ("Franchised Area"). The number of franchises which can operate and perform CHEM-DRY Businesses per Franchised Area at any given time is determined by dividing the current population of the area by 60,000. The nearest whole number to the quotient (the "Maximum Number") is the maximum number of franchises that HRI may grant in the area for operating and conducting a CHEM-DRY Business. The Franchised Area will be determined by HRI based on population, population density, geographical terrain and market potential. Based on population changes, the Maximum Number may increase or decrease from time to time and may not remain constant; however the Maximum Number only affects HRI's ability to grant franchises and no franchise will be terminated solely as a result of a decrease in the Maximum Number.

FRANCHISEE agrees to operate and conduct his or her business from a single location within the Franchised Area from which he or she may operate as many crews, teams, sales forces and vans as he or she desires. In the event FRANCHISEE has multiple franchises, a separate cleaning crew must be available for each franchise to perform requested work within the Franchised Area for the approved services. All vans and equipment must be returned to the place of business within the Franchised Area at the end of each business day.

FRANCHISEE agrees to advertise and solicit business for the authorized services within the Franchised Area only. FRANCHISEE further agrees that FRANCHISEE will accept and perform only those jobs that are within the Franchised Area, except jobs done on a bona fide referral basis. The following is the only situation which is considered to be a bona fide referral: The customer must be referred to FRANCHISEE by another person who first utilized FRANCHISEE'S services within the Franchised Area, and the referred customer must initiate contact with FRANCHISEE and specifically request that FRANCHISEE come to his/her home or place of business to perform carpet, drapery or upholstery cleaning services. Prior to FRANCHISEE accepting this work, FRANCHISEE must first inform the customer of any franchises within the customer's Franchised Area that could perform the services requested. If the customer declines to be serviced by the local, authorized franchise, FRANCHISEE will be allowed to proceed with the job. The following are examples of situations which are not considered bona fide referrals: The customer first heard about FRANCHISEE through a yellow page ad, a listing in a phone book, a newspaper ad, or any form of advertisement; the customer saw FRANCHISEE'S van; the customer saw FRANCHISEE'S services being performed; the customer saw FRANCHISEE'S business card; the customer heard about FRANCHISEE through someone who had received services from FRANCHISEE outside of the Franchised Area, or the customer was told about FRANCHISEE from a retail store of any kind.

When FRANCHISEE receives a bona fide referral, FRANCHISEE must follow the following procedure: The customer receiving services must complete and sign a Customer Referral Card. FRANCHISEE must keep all Customer Referral Cards on file, attached to the invoice for the respective job, in FRANCHISEE'S permanent files for a minimum of five (5) years. Each time FRANCHISEE services a customer through a bona fide referral, the customer must complete a Customer Referral Card, whether or not FRANCHISEE has serviced that customer before. There must be a Customer Referral Card for each job FRANCHISEE performs outside the Franchised Area. FRANCHISEE must make all records, including the copy of the invoice and the Customer Referral Card, available to any Harris Research, Inc. representative who visits FRANCHISEE'S place of business during regular business hours. In addition, FRANCHISEE must send to Harris Research, Inc., upon request, copies of any and all Customer Referral Cards for work done within the past five (5) year period. Failure to comply with any of these requirements will be considered a material breach of this Agreement and can be cause for loss of the franchise through termination of this Franchise Agreement. Should a dispute arise between franchisees in conjunction with this clause, each franchisee agrees to abide by a decision and follow corrective guidelines rendered by an arbitration board consisting of members who are selected pursuant to the policies established by HRI from time to time. In addition to any other remedies, the arbitration board shall have the power to impose fines or costs on the parties to the arbitration. Failure to comply with any of these requirements will be considered a material breach of this Agreement and can be cause for loss of the franchise through termination of this Franchise Agreement.

FRANCHISEE agrees that he or she will at all times faithfully, honestly and diligently perform his or her obligations hereunder and that he or she will continuously exert his or her best efforts to effectively promote and enhance his or her CHEM-DRY Business and develop and service customers within his or her Franchised Area.

HRI reserves the right in its sole discretion:
subject to the foregoing limitations on the Maximum Number of franchises in a Franchised Area, to grant franchises for any area and on any terms HRI deems appropriate;

(2) to develop, sell, manufacture or distribute any type of product or service identified by or associated with the Marks in any channel of distribution, including but not limited to sales to retail outlets which may operate in proximity to FRANCHISEE; and

(3) to develop, sell, manufacture or distribute any type of product or service identified by trademarks or service marks other than the Marks in any channel of distribution.

2. TRAINING AND GUIDANCE.

*A. TRAINING.*

HRI shall furnish a training program on the operation of the CHEM-DRY Business which the FRANCHISEE is required to complete prior to contracting with customers. HRI agrees to provide FRANCHISEE with initial training on how to (1) mix and apply cleaning solutions, use equipment in cleaning the work product and performing the services required for the CHEM-DRY Business under normal working conditions; (2) compute estimates; (3) solicit and maintain business; and (4) replace inventory and otherwise enter into and conduct a CHEM-DRY Business. Before opening, FRANCHISEE must complete the initial training on the operation of a CHEM-DRY business and FRANCHISEE must train his employees. If

FRANCHISEE purchases a new franchise from HRI, FRANCHISEE will be required to attend a training session at HRI corporate headquarters in Logan, Utah, or another designated location at HRI's sole discretion, within 90 days of the franchise purchase. HRI will pay the travel and training expenses for one new owner of each franchise to attend. If FRANCHISEE is a transferee, FRANCHISEE must complete the initial training within 90 days of franchise purchase by attending a training session at or near HRI's corporate headquarters in Logan, Utah at such time as HRI designates. FRANCHISEE is responsible for all travel expenses and living expenses which are incurred in connection with the training program. If HRI determines, at its sole discretion, that FRANCHISEE failed to satisfactorily complete the training program, HRI shall have the right to require FRANCHISEE to attend the next initial training program at FRANICHISEE'S expense (including all travel and living expenses incurred); or view video tape(s) and pass the accompanying workbook test. If FRANCHISEE's performance in the additional training program is unsatisfactory, HRI shall have the right to terminate this Agreement effective upon delivery of notice of termination to FRANCHISEE.

FRANCHISEE is required to keep updated in his or her training, and shall complete a training course for each authorized franchised service at least once every calendar year at the FRANCHISEE's own expense. The initial training will fulfill the training requirement for the calendar year in which the Franchise Agreement is dated. In subsequent calendar years, the training must be updated by December 31 st of each year. This updated training can be completed by two methods: the FRANCHISEE can attend an authorized training session given at a location selected by HRI; or the FRANCHISEE may purchase the most current edition of the video training tape(s) and then successfully complete the accompanying tests.

*B. GUIDANCE.*

HRI shall furnish to FRANCHISEE guidance in connection with the operation of his or her CHEMDRY Business. New ideas or *inventions when made* or obtained by HRI will be made available to Franchisees at HRI's sole discretion. In the sole discretion of HRI, it shall furnish such guidance in the form of HRI's training manual (which may consist of one or more separate manuals) for the operation of a CHEMDRY Business (the "Manual"), newsletters or other written materials, telephonic conversations and/or consultation at the offices of HRI or FRANCHISEE. Additional guidance and assistance shall be available, in the sole discretion of HRI, at per them fees and charges established from time to time by HRI.

During the term of the Franchise, HRI will loan to FRANCHISEE one copy of the Manual which contains mandatory and suggested specifications, standards and operating procedures prescribed from time to time by HRI for the operation of a CHEM-DRY Business and information relative to other obligations of FRANCHISEE hereunder. HRI shall have the right to add to and to otherwise modify the Manual from time to time to reflect changes in authorized products, services and equipment, standards of product and service quality and performance, and the operation of the CHEM-DRY Business, provided that no such addition or modification shall alter FRANCHISEE's fundamental status and rights under this Agreement. FRANCHISEE shall keep his or her copy of the Manual current; however, in the event of a dispute, the master copy maintained by HRI at its principal office shall be controlling. FRANCHISEE shall not, at any time, copy or distribute any part of the Manual.

3. MARKS.

*A. OWNERSHIP AND GOODWILL OF MARKS.*

FRANCHISEE acknowledges that his or her right to use the Marks is derived solely from this Agreement and is limited to his or her conduct of business pursuant to and in compliance with this Agreement and all applicable standards, specifications and operating procedures prescribed by HRI from time to time during the term of the Franchise. Any unauthorized use of the Marks by FRANCHISEE shall constitute an infringement of the rights of HRI in and to the Marks. FRANCHISEE agrees that all usage of the Marks by FRANCHISEE and any goodwill established thereby shall inure to the exclusive benefit of HRI and FRANCHISEE acknowledges that this Agreement does not confer any goodwill or other interests in the Marks upon FRANCHISEE. All provisions of this Agreement applicable to the Marks shall apply to any additional proprietary trade and service marks and commercial symbols HRI hereafter authorizes for use by FRANCHISEE. FRANCHISEE shall immediately notify HRI of any apparent infringement of or challenge to FRANCHISEE's use of any Mark. HRI shall have sole discretion to take such action as it deems appropriate and the right to exclusively control any litigation or proceeding arising out of any such infringement or challenge. FRANCHISEE agrees to render such assistance in connection therewith as HRI deems necessary or advisable.

*B. LIMITATIONS ON FRANCHISEE'S USE OF MARKS.*

FRANCHISEE agrees to use the Marks as the sole identification of his or her Franchise, provided that FRANCHISEE shall identify himself or herself as the independent owner and operator thereof in the manner prescribed by HRI. FRANCHISEE shall not use any Mark as part of any corporate name or with any prefix, suffix or other modifying words, terms, designs or symbols (other than logos licensed to FRANCHISEE hereunder), or in any modified form, nor may FRANCHISEE use any Mark in connection with the performance or sale of any unauthorized services or products or in any other manner not expressly authorized in writing by HRI. FRANCHISEE agrees to prominently display the Marks and only the Marks (as prescribed in Section TA. hereof) on each van used by FRANCHISEE in connection with the operation of his or her CHEM-DRY Business, and on contracts, forms, equipment, uniforms and other materials authorized by HRI. FRANCHISEE further agrees that FRANCHISEE's telephone number shall be used exclusively for the operation of FRANCHISEE's CHEM-DRY Business and for no other purpose. Promotion of the CHEM-DRY Business by use of the intemet must adhere to the current Advertising Rules & Guidelines.

FRANCHISEE agrees to give such notices of trade and service mark registrations as HRI specifies and to obtain such fictitious or assumed name registrations as may be required under applicable law. If, in HRI's sole discretion, it becomes advisable for HRI and/or FRANCHISEE to modify or discontinue use of any Mark and/or use one or more additional or substitute trade or service marks, FRANCHISEE agrees to comply with HRI's directions to modify or otherwise discontinue the use of such Mark within a reasonable time after notice thereof. HRI shall reimburse FRANCHISEE for his or her reasonable direct expenses in modifying or discontinuing the use of the service mark, trademark and trade name "CHEM-DRY" and substituting for it a different service mark, trademark or trade name; however, HRI shall not be obligated to reimburse FRANCHISEE for any loss of revenue or goodwill associated with any modified or discontinued Mark or for any expenditures made by FRANCHISEE to promote a modified or substitute trademark or

4. CONFIDENTIAL INFORMATIONIEXCLUSIVE RELATIONSHIP.

HRI possesses certain confidential information relating to the methods, techniques, formats, specifications, procedures, information, systems, sales and marketing techniques and knowledge of and experience in the development, operation and franchising of CHEM-DRY Businesses (the "Confidential Information"). HRI will disclose the Confidential Information to FRANCHISEE in the training program, the Manual and in guidance furnished to FRANCHISEE. FRANCHISEE acknowledges that the Confidential Information is proprietary and involves trade secrets of HRI and that he or she will not acquire any interest in the Confidential Information, other than the right to utilize it in the operation of a CHEM-DRY Business during the term of this Agreement.

FRANCHISEE acknowledges and agrees that HRI would be unable to protect the Confidential Information against unauthorized use or disclosure if franchised owners of CHEM-DRY Business were permitted *to hold interests in* any Competitive Business (as defined below). FRANCHISEE therefore agrees that during the term of this Agreement, neither FRANCHISEE, nor any member of his or her or their Immediate families shall perform services or have any direct or indirect interest as a disclosed or beneficial owner, investor, partner, director, officer, employee, manager, consultant, representative or agent or in any other capacity in any Competitive Business.

The term "Competitive Business as used in this Agreement shall mean any business which provides, or grants franchises or licenses to others *to provide, carpet or upholstery/drapery* cleaning, spotting or protective services or any related or ancillary services.

5. RELATIONSHIP OF THE PARTIESIINDEMNIFICATION.

Is understood and agreed by the parties hereto that this Agreement *does not create a fiduciary* relationship between them, that HRI and FRANCHISEE shall be independent contractors and that nothing in this Agreement is intended to make either party a general or special agent, joint venturer, partner or employee of the other for any purpose. FRANCHISEE shall conspicuously identify himself or herself in all dealings with customers, suppliers, public officials and others as the owner of his or her business under a franchise with HRI and shall place such other notices of independent ownership on such forms and other materials as HRI may require from time to time. FRANCHISEE shall hire all employees of his or her CHEMDRY Business, and will be exclusively responsible for the terms of their employment, compensation and proper training-, however, FRANCHISEE shall not hire, retain or utilize any independent contractors to perform services for his or her customers., FRANCHISEE shall have no right to offer or sell any subfranchises, sublicenses or other form of delegation of rights under thisAgreement.

FRANCHISEE shall not employ any of the Marks in signing any contract or applying for any license or permit or in a manner that may result in HRI's liability for any of FRANCHISEE's indebtedness or obligations, nor may FRANCHISEE use the Marks in any way not expressly authorized by HRL Except as expressly authorized by this Agreement, FRANCHISEE shall make no express or implied agreements, warranties, guarantees or representations, or incur any debt, in the name of or on behalf of HRI and HRI shall not be obligated by or be liable under any agreements or representations made by FRANCHISEE that are not expressly authorized hereunder. HRI shall have no liability for any sales, use, occupation, excise, gross receipts, income, property or other taxes, whether levied upon FRANCHISEE, the Franchise, FRANCHISEE's property or HRI, in connection with the sales or payments made or business conducted by FRANCHISEE.

FRANCHISEE agrees to indemnify and hold HRI, its affiliates, shareholders, directors, officers, employees, agents, successors and assignees harmless from and against any liability for any claims arising out of the operation of his or her CHEM-DRY Business. For purposes of this indemnification, claims shall mean and include all obligations, actual and consequential damages, taxes and costs reasonably incurred in the defense of any claim, including, without limitation, reasonable accountants', attorneys' and expert witness fees, costs of investigation and proof of facts, court costs, other litigation expenses and travel and living expenses. HRI shall have the right to defend any such claim in which it is named as a defendant. This indemnity shall continue in full force and effect subsequent to and notwithstanding the expiration or termination of this Agreement.

6. FEES.

*A. INITIAL FRANCHISE FEE.*

FRANCHISEE agrees to pay to HRI a non-refundable initial franchise fee of Eighteen Thousand Nine Hundred Fifty Dollars ($18,950.00) (the "Initial Franchise Fee") comprised of the following components:

(1) An initial license fee of Ten Thousand Nine Hundred Fifty One Dollars ($10,951.00) for the right to use the Marks during the term of this Agreement; and

(2) An initial advertising, cleaning solution and equipment package fee of Seven Thousand Nine Hundred Ninety Nine Dollars ($7,999.00) plus applicable taxes.

Prior to signing this Agreement, FRANCHISEE must pay HRI in cash the non-refundable sum of Five Thousand Nine Hundred Fifty Dollars ($5,950.00) as a down payment. FRANCHISEE must pay HRI the remainder of the purchase price as follows: beginning with the fourth (4th) month following the Agreement Date, FRANCHISEE shall pay to HRI the non-refundable sum of Two Hundred Thirty Two Dollars and Fourteen Cents ($232.14) per month for fifty six (56) consecutive months towards the remaining balance of the purchase price. Outstanding balances of the purchase price bear 0% interest. All payments are due on or before the tenth (10th) day of each month.

*B. MONTHLY FRANCHISE FEE.*

Beginning with the fourth (4th) month following the Agreement Date, and continuing for each consecutive month thereafter, FRANCHISEE will pay to HRI on or before the tenth (loth) day of each succeeding month the non-refundable monthly franchise fee payment, which is currently One Hundred Eighty Nine Dollars and Sixty Seven Cents ($189.67). The monthly franchise fee payment for renewing, transferring and/or Special Program franchises* begins the month following the Agreement Date. These amounts shall be increased not more than once each calendar year to reflect increases in the Metropolitan Area Consumer Index for Urban Consumers-All Items (1982–1984 = (1100) from the Agreement Date, as published by the U.S. Department of Labor or in a successor index (the "Consumer Price Index").

*C. INTEREST ON LATE PAYMENTS.*

All franchise fees, amounts due for purchases by FRANCHISEE from HRI, and other amounts which FRANCHISEE owes to HRI shall bear interest after due date at the highest applicable legal rate for open account business credit in the state of FRANCHISEE's domicile, not to exceed one and one-half percent (1.5%)Permonth. FRANCHISEE acknowledges that this section shall not constitute HRI's agreement to accept such payments after same are due or a commitment by HRI to extend credit to, or otherwise finance FRANCHISEE's CHEM–DRY Business.

*D. APPLICATION OF PAYMENTS.*

Notwithstanding any designation by FRANCHISEE, HRI shall have sole discretion to apply any PaYrnents by FRANCHISEE to any of his or her past due indebtedness for fees, purchases from HRI or its affiliates, interest or any other indebtedness.

*A. CONDITION AND APPEARANCE OF VANS AND EQUIPMENT.*

FRANCHISEE agrees to purchase or lease one or more van(s) suitable for the purpose of transporting various equipment, supplies and materials needed to operate a CHEM–DRY Business and which otherwise meets HRI's specifications. The van(s) must be used for all cleaning jobs. FRANCHISEE agrees: (1) to maintain the condition and appearance of his or her van(s) according to the current Advertising Rules and Guidelines and maintain the condition of the equipment consistent with the image of the CHEM–DRY Business as a professionally operated services business; (2) that the equipment shall not be used for any purpose other than the operation of his or her CHEM–DRY Business as described herein; (3) to place or display on the van(s) and equipment only such signs, emblems, lettering and logos as are approved by HRI, and no others; (4) not to sell or otherwise transfer any of the van(s) without first removing all of the Marks from the van(s).

*B. MUIPMENT. PRODUCTS AND SERVICES.*

FRANCHISEE agrees to use only equipment, cleaning solutions, supplies and promotional materials which have either been obtained from or approved by HRI from time to time. FRANCHISEE agrees to purchase all cleaning solutions only from HRI and at the then current list price, plus applicable taxes, and to pay for all purchases no later than thirty (30) days from the invoice date. FRANCHISEE Is required to purchase a minimum of Two Thousand Dollars ($2,000.00) (increased not more than once each calendar year to reflect increases in to Consumer Price Index) of cleaning solution Items from HRI each calendar year ("Minimum Purchase Amount"). FRANCHISEE may purchase other equipment, product or supply items from HRI at the then current list price, plus applicable taxes, and to pay for all purchases no later than thirty (30) days from the invoice date. If FRANCHISEE proposes to purchase or lease any equipment, product or supply item which is not then approved by HRI, FRANCHISEE shall first notify HRI in writing and, upon request, furnish to HRI specifications, photographs, drawings and/or other information sufficient to HRI a reasonable opportunity to determine whether such equipment, product or supply item complies *with its specifications* and standards. If FRANCHISEE possesses or uses NON CHEM–DRY cleaning solutions in the CHEM–DRY Business, FRANCHISOR shall have the right to impose on FRANCHISEE a fine of up to Two Thousand Dollars ($2,000) and if the violations are repeated the FRANCHISEE is subject to termination.. FRANCHISEE shall install or have installed a business telephone. FRANCHISEE agrees to maintain and answer such telephone with the full approved business name during regular business hours and have installed a Voice Mail/Answering Machine system to capture customer calls after hours within 60 days of the Agreement Date.

*C. AUTHORIZED PRODUCTS AND SERVICES.*

The reputation and goodwill of HRI is based upon, and can be maintained and enhanced only by furnishing high quality carpet and upholstery/drapery cleaning, spotting and protecting services and other related products and services. FRANCHISEE agrees, therefore, that he or she will only offer such cleaning, spotting and protecting products and services that HRI shall authorize for the CHEM–DRY Business. FRANCHISEE further agrees that he or she will not sell his or her CHEM–DRY customer list(s) or customer contracts, or otherwise use his or her CHEM–DRY customer list(s) for any purpose other than in connection with the operation of his or her CHEM–DRY Business. FRANCHISEE agrees that he or she will not, without the prior written approval by HRI, offer or sell any type of service or offer, sell or use any product that is not authorized by HRI for the CHEM–DRY Business. FRANCHISEE will not resell any type of cleaning solutions without the express written approval of HRI. FRANCHISEE further agrees that the equipment used in CHEM-DRY Businesses shall not be used for any purpose other than the operation of his or her CHEM-DRY Business in compliance with this Agreement and in the manner in which it was Intended and according to operating procedures as outlined in the Training Manual

7. FRANCHISE IMAGE AND OPERATING PROCEDURESD. SPECIFICATIONS, STANDARDS AND PROCEDURES.

FRANCHISEE agrees to cooperate with HRI by maintaining high standards in the operation of his or her CHEM-DRY Business. FRANCHISEE also agrees to comply with all mandatory specifications, standards and operating procedures relating to the operation of a CHEM-DRY Business. Mandatory specifications, standards and operating procedures prescribed from time to time hy HRI in the Manual for the CHEM-DRY Business, or otherwise communicated to FRANCHISEE in writing, shall constitute provisions of this Agreement as if fully set forth herein. All references herein to this Agreement shall include all such mandatory specifications, standards and operating procedures.

*E. COMPLIANCE WITH LAWS AND GOOD BUSINESS PRACTICES.*

FRANCHISEE shall secure and maintain in force in its name all required licenses, permits and certificates relating to the operation of his or her CHEM-DRY Business. FRANCHISEE shall operate his or her Franchise in full compliance with all applicable laws, ordinances and regulations, including without limitation all government regulations relating to environmental protection, occupational hazards and health, worker's compensation insurance, unemployment insurance and withholding and payment of federal and state income taxes, social security taxes and sales taxes. FRANCHISEE shall, in all dealings with his or her customers, suppliers, HRI and the public, adhere to the highest standards of honesty, integrity, fair dealing and ethical conduct, including hut not limited to, performing approved services pursuant to the CHEM-DRY Business within a reasonable amount of time from a customer's request. FRANCHISEE agrees to refrain from any business or advertising practice which may be injurious to the husiness of HRI and the goodwill associated with the Marks and other CHEM-DRY Businesses.

*F. INSURANCE.*

FRANCHISEE shall at all times during the term of the Franchise maintain in force at his or her sole expense comprehensive public, product and motor vehicle liability insurance against claims for bodily and personal injury, death and property damage caused by or occurring in conjunction with the operation of FRANCHISEE's CHEM-DRY Business. Such insurance coverage shall be maintained under one or more policies of insurance containing minimum liability protection in such amounts as are specified by HRI from time to time and issued by insurance carriers acceptable to HRI. The insurance coverage for CHEM-DRY Business must also state that the work product is covered and that there is no 'Workmanship" or "care, custody, and control" exclusion. All liability insurance policies required hereunder shall name HRI (its officers, directors, employees and designated affiliates) as additional insureds and shall provide that HRI receives thirty (30) days prior written notice of termination, expiration or cancellation of any such policy. Upon sixty (60) days prior written notice to FRANCHISEE, HRI may increase the minimum liability protection requirements and require different or additional kinds of insurance at any time, to reflect inflation, identification of new risks, changes in law or standards of liability, higher damage awards, product or motor vehicle liability litigation or other relevant changes in circumstances. FRANCHISEE shall furnish annually to HRI a copy of the certificate.

8. MARKETING AND PROMOTION.

Prior to commencing the conduct of his or her CHEM-DRY Business, FRANCHISEE agrees to list his or her CHEM-DRY Business in the principal regular (white pages) and classified (yellow pages) telephone directories distributed within FRANCHISEE's Franchised Area, and in such directory categories as are specified by HRI.

In order to obtain maximum results from promotional materials and to maintain the integrity of HRI's Marks, FRANCHISEE shall not use promotional materials of any kind that have not been supplied by HRI or, if FRANCHISEE develops or obtains any promotional materials from a source other than HRI, such materials must be in compliance with HRI's current guidelines. FRANCHISEE may submit promotional material to HRI for HRI's approval. If approved, HRI shall have the right to duplicate and distribute such materials to all FRANCHISEES.

If the FRANCHISEE uses any promotional material which is not in compliance with HRI's current advertising guidelines, he or she may be subject to a fine of Two Thousand Dollars ($2,000.00) and/or termination of the Franchise.

HRI may require participation in national and other marketing promotions from time-to-time. This includes, without limitation, promotional programs and/or national account programs. HRI may, from time-to-time, set maximum prices on services and products offered by franchisees. If HRI imposes such maximum prices, FRANCHISEE may charge any price for such services, up to and including, the maximum price as set by HRI. This includes, without limitation, promotional prices and/or national account pricing.

9. RECORDS AND REPORTING.

*A. ACCOUNTING AND RECORDS.*

FRANCHISEE agrees, at his or her expense, to maintain and preserve for five (5) years from the date of their preparation, or such greater period as may be required by the Manual or applicable law, full, complete and accurate books, records and accounts including, without limitation copies of all customer contracts and lists, employee records, sales, invoices, cash receipts, service records, purchase records, accounts payable, cash disbursement records, inventory records, general ledgers, itemized bank deposit slips and bank statements, copies of sales tax returns, and copies of FRANCHISEE's state and federal income tax returns. These records must be maintained in the English language.

*B. REPORTING REQUIREMENTS.*

FRANCHISEE shall furnish HRI, at HRI's request, in the form from time to time prescribed by HRI, a control report signed and verified by FRANCHISEE accurately reflecting the gross and net revenues of FRANCHISEE's CHEM–DRY Business for the preceding specified time period and copies of all customer invoices during such time period. FRANCHISEE, at his or her expense, shall furnish to HRI (and its agents) for inspection, audit and copying, such forms, reports, records, financial statements and other information as HRI may, from time to time require.

If HRI is required by any government agency to collect financial information from franchisees, FRANCHISEE shall furnish HRI, by *May 1* of each year, or any other date necessary to meet such reporting requirements, a copy of the appropriate Federal Tax Form showing income and expenses for the CHEM–DRY Business. The appropriate form may include, but is not limited to: Form 1120 (Corporation), Form 11 20S (Sub-Chapter S), Schedule C (Sole Proprietorship), or Form 1065 (Partnership).

10. INSPECTIONS AND AUDITS.

To determine whether FRANCHISEE is complying with this Agreement and/or all applicable specifications and quality standards, HRI shall have the right at any reasonable time and without prior notice to FRANCHISEE to: (a) inspect FRANCHISEE's equipment and the van(s); (b) inspect FRANCHISEE's location which it operates; (c) observe FRANCHISEE and all employees in the performance of services; (d) inspect any job performed by FRANCHISEE; and (e) contact and interview customers of FRANCHISEE. If, upon inspection or investigation, HRI finds that the quality of work done by FRANCHISEE is substandard, HRI may, as an alternative to termination, require FRANCHISEE, at its own expense, to take additional training and to correct the quality of its work and services.

HRI shall have the further right at any time during business hours, and with at least three (3) days' prior notice to FRANCHISEE, to inspect and audit, or cause to be inspected and audited, the business records, bookkeeping and accounting records, sales and income tax records and returns and other records of FRANCHISEE's CHEM–DRY Business. FRANCHISEE further acknowledges and agrees that HRI shall have the right to make photocopies of all such books and records. FRANCHISEE shall fully cooperate with representatives of HRI and independent accountants hired by HRI to conduct any such inspection or audit. If FRANCHISEE fails to provide any such books, records and other materials requested at such inspection/audit in the format prescribed by HRI in the Manual or in writing, then FRANCHISEE shall pay HRI Five Hundred Dollars ($500.00) for each day any such requested books, records and other materials are not available to HRI plus HRI's reasonable expenses incurred in connection with such delay.

11. TRANSFER.

*A. BY HRI.*

This Agreement and the Franchise are fully transferable by HRI and shall inure to the benefit of any transferee or other legal successor to HRI's interest herein.

*B. FRANCHISEE MAY NOT TRANSFER WITHOUT HRI APPROVAL.*

FRANCHISEE understands and acknowledges that the rights and duties created by this Agreement are personal to FRANCHISEE and that HRI has granted the Franchise in reliance upon HRI's perceptions of the individual(s) or collective character, business skill, aptitude and financial capacity of FRANCHISEE. Therefore, neither this Agreement, the assets relating to FRANCHISEE'S CHEM-DRY Business (the "Business Assets'), nor the Franchise may be transferred without HRI's prior written approval, and any such transfer shall constitute a breach of this Agreement and convey no rights to or interests in this Agreement, FRANCHISEE'S CHEM-DRY Business or the Business Assets. The franchised business as a whole must be transferred to the new owner and FRANCHISEE cannot sell any rights, products, customer lists or any item separate from the sale of the franchise. The term "Business Assets" includes, but is not limited to, customer lists, customer contracts and any other information relating to customers of FRANCHISEE's CHEM-DRY Business.

As used in this Agreement, the term "transfer" means and includes a voluntary, involuntary, direct or indirect assignment, sale, gift or other disposition by FRANCHISEE of any interest in this Agreement, the Business Assets or the CHEM-DRY Business. An assignment, sale, gift or other disposition shall include the following events: (1) transfer of the Business Assets in a divorce, insolvency or otherwise by operation of law, or (2) transfer of the Business Assets in the event of the death of FRANCHISEE by will, declaration of a transfer in trust, or under the laws of intestate succession. Any such assignment or transfer without such approval shall constitute a breach hereof and convey no rights to or interests in FRANCHISEE's CHEM-DRY Business, this Agreement, the Business Assets or the Franchise.

*C. CONDITIONS FOR APPROVAL OF TRANSFER.*

If FRANCHISEE is in full compliance with this Agreement, HRI shall not unreasonably withhold its approval of a transfer that meets all of the applicable requirements of this Section 1 1.C. In no event will HRI be liable for any damages suffered by either FRANCHISEE or the transferees for failure to approve the transfer in a timely manner. The proposed transferee(s) must be an individual of good moral character, have sufficient business experience, aptitude and financial resources to own and operate a CHEM-DRY Business and to otherwise meet HRI's then applicable standards for franchisees. All of the following conditions must be met prior to, or concurrently with, the effective date of the transfer (1) all obligations of FRANCHISEE incurred in connection with this Agreement and the conduct of his or her CHEM-DRY Business, including but not limited to, obligations to customers of FRANCHISEE, must be assumed by the transferee(s); (2) FRANCHISEE must pay all amounts owed to HRI which are then due, and shall have submitted to HRI all required reports and statements; (3) the transferee(s) must satisfactorily complete the training program required of new franchisees; (4) the transferee(s) must execute and agree to be bound by HRI'S then current form of standard franchise agreement and such ancillary agreements as are then customarily used by HRI in the transfer of CHEM-DRY Businesses, which may provide for different rights and obligations than are provided by this Agreement, but which franchise agreement does not provide for Payment of an Initial Franchise Fee; (5) FRANCHISEE or the transferee(s) must pay a transfer fee to HRI in an amount equal to the greater of Seven Hundred Fifty Dollars ($750.00), or six percent (6%) of the purchase price as agreed to between the buyer and FRANCHISEE up to a maximum of Two Thousand Dollars ($2,000.00) (the dollar amounts stated in this subsection are to be increased not more than once per calendar year to reflect increases in the Consumer Price Index); (6) FRANCHISEE must execute a general release, in form satisfactory to HRI, of any and all claims against HRI, its affiliates, officers, directors, employees and agents; (7) HRI has the right to disapprove any transfer if it determines that the material terms and conditions of such transfer (including price and terms of payment) could adversely affect the future operations of the Franchise; (8) HRI has the right to inspect the equipment and the van(s) to be transferred to transferee(s) and to require cleaning, repair or reconditioning thereof by FRANCHISEE prior to transfer, (9) FRANCHISEE must execute a noncompetition covenant in favor of HRI and the transferee(s), agreeing that for a period of not less than three (3) years, commencing on the effective date of the transfer, he, she, or they and the members of his or her and their immediate families will not have any direct or indirect interest as a disclosed or beneficial owner, investor, lender, partner, director, officer, manager, consultant, employee, representative or agent, or in any other capacity, in any Competitive Business located within (a) FRANCHISEE's Franchised Area, (b) ten (10) miles of the boundary of FRANCHISEE's Franchised Area, (c) the franchised area of any other CHEM–DRY Business, or (d) ten (10) miles of the boundary of the franchise area of any other CHEM–DRY Business; (10) FRANCHISEE shall have entered into an agreement with HRI agreeing to subordinate to the transferee's obligations to HRI, any obligations of such transferee to make installment payments of the purchase price to FRANCHISEE; (11) the purchase agreement between the FRANCHISEE and the transferee(s) must include (a) a dollar breakdown of the sale price allocated to goodwill, covenant not to compete, van(s), cleaning equipment, cleaning supplies and office equipment and supplies; and (b) a statement that FRANCHISEE has made a full disclosure to the transferee(s) and they have agreed upon the disposition of all outstanding obligations and accounts receivable of the franchise; and (12) FRANCHISEE purchases the Velda H.C.U. equipment with all required attachments and uses only the cleaning process with the Velda H.C.U. equipment. Subsection (7) shall not apply to transfers by gift, bequest or inheritance.

*D. DEATH OR INCAPACITY OF FRANCHISEE.*

Upon receipt of notification of the death or permanent incapacity of FRANCHISEE or within six (6) months thereafter, HRI shall have the right, but not the duty, to repurchase the Franchise at a price to be determined by an independent appraiser selected by both HRI's and FRANCHISEE's representatives and upon such terms and conditions as may be mutually agreeable to both parties. If HRI does not exercise this repurchase right, the executor, administrator, conservator or other personal representative of such person must transfer his or her interest to a third party approved by HRI within six (6) months from the date of death or permanent disability. Such transfer shall be subject to all of the terms and conditions for transfers contained in this Section 11. Failure to transfer in accordance with this Section upon such death or disability shall constitute a breach of this Agreement.

*E. HRI'S RIGHT OF FIRST REFUSAL.*

If FRANCHISEE shall at any time determine to sell an interest in FRANCHISEE's CHEM–DRY Business or the Business Assets, FRANCHISEE shall obtain a bona fide, executed written offer from a responsible and fully disclosed purchaser and shall submit an exact copy of such offer to HRI. HRI shall have the right, exercisable by written notice delivered to FRANCHISEE within thirty (30) days from the date of delivery of an exact copy of such offer to HRI, to purchase such Business Assets, for the price and on the terms and conditions contained in such offer, provided that HRI may substitute cash for any form of payment proposed in such offer and shall have not less than thirty (30) days to prepare for closing. If HRI does not exercise its right of first refusal, FRANCHISEE may complete the sale to such purchaser pursuant to and on the terms of such offer, subject to HRI's approval of the purchaser as provided in Section 1 1.C., provided that if the sale to such purchaser is not completed within ninety (90) days after delivery of such offer to HRI, or there is a material change in the terms of the sale, HRI shall again have the right of first refusal herein provided.

## 12. EXPIRATION OF THIS AGREEMENT.

*A. FRANCHISEE'S RIGHT TO ACQUIRE A SUCCESSOR FRANCHISE.*

Subject to the provision of this Section 12, upon expiration of the initial term of the Franchise, if: (1) FRANCHISEE has substantially complied with all of the provisions of this Agreement; (2) FRANCHISEE, if necessary, refurbishes and re-equips each of his or her van(s) and commissions HRI (or another party approved by HRI), at his or her expense and on his or her behalf, to repair or replace the equipment utilized in the operation of the Franchise; (3) FRANCHISEE is in compliance with specifications and standards then applicable for new CHEM–DRY Business franchises; (4) FRANCHISEE pays HRI the then current renewal fee; and (5) FRANCHISEE purchases the Velda H.C.U. equipment with all required attachments and uses only the cleaning process with the Velda H.C.U. equipment; then FRANCHISEE shall have the right to acquire a successor franchise for the CHEM–DRY Business for an additional term of five (5) years.

*B. GRANT OF A SUCCESSOR FRANCHISE.*

FRANCHISEE must give HRI written notice of his or her election to acquire a successor franchise no earlier than nine (9) months and no later than six (6) months before the end of the initial term of this Agreement. Within thirty (30) days after delivery of FRANCHISEE'S notice, HRI shall notify FRANCHISEE in writing whether or not HRI shall grant a successor franchise to FRANCHISEE. If, at any time during the term of this Agreement, FRANCHISEE fails to fully comply with this Agreement or any other agreement between FRANCHISEE and HRI, HRI may refuse to grant a successor franchise by delivering a notice of HRI's refusal to grant a successor franchise, stating the reasons for such refusal. If HRI'S notice indicates that HRI will permit FRANCHISEE to obtain a successor franchise, such right will be contingent upon FRANCHISEE'S continued full compliance with this Agreement, including being current in financial obligations to HRI, and any other agreement between HRI and FRANCHISEE.

*C. AGREEMENTSIRELEASES.*

If HRI grants a successor franchise, HRI and FRANCHISEE shall execute HRI's then current form of franchise agreement and such ancillary agreements as are used in offering franchises for the ownership and operation of CHEM-DRY Businesses (with appropriate modifications to reflect the fact that the agreements relate to the grant of a successor franchise), and HRI and FRANCHISEE shall execute general releases, in form satisfactory to HRI, of any and all claims against each other and their respective affiliates, officers, directors, employees and agents. Failure by FRANCHISEE to sign such agreement(s) and releases within ninety (90) days after delivery thereof to FRANCHISEE shall be deemed an election by FRANCHISEE not to acquire a successor franchise.

13. TERMINATION OF FRANCHISE BY HRL

This Agreement shall terminate:

(1) effective upon delivery of notice*of termination to FRANCHISEE if FRANCHISEE:

(a) abandons or fails to actively operate the Franchise or fails to commence operation of his or her CHEM-DRY Business as required in Section 1.B. of this Agreement; (b) surrenders or transfers control of the CHEM-DRY Business without HRI's prior written consent; (c) has made any material misrepresentation or omission in his or her franchise application or after being granted the Franchise; (d) fails to satisfactorily complete the training requirements described in Section 2.A. of this Agreement; (e) is convicted of or pleads no contest to a felony, or any other crime or offense that is likely to adversely affect the reputation of FRANCHISEE, other CHEM-DRY Businesses or HRI; (f) abandons, surrenders or makes an unauthorized transfer of the Franchise or the Business Assets; (g) makes any unauthorized use, duplication or disclosure of any Confidential Information or the Manual; (h) fails on two or more separate occasions during any one year period to submit when due reports or other data, information or supporting records, to pay the fees, Minimum Purchase Amounts, product invoices or any other amounts due to HRI, or otherwise fails to comply with this Agreement, whether or not such failures to comply are corrected after notice thereof is delivered to FRANCHISEE; (i) uses non-CHEM-DRY cleaning solutions on two or more occasions; a) Materially misuses or makes an unauthorized use of any Mark or commits any act which can reasonably be expected to materially impair the goodwill associated with any Mark; (k) incorporates a corporation under a name which includes any of the Marks; (1) violates any *environmental, health, safety*, sanitation or other regulatory law, ordinance or regulation or conducts his or her CHEM-DRY Business in a manner that presents a health or safety hazard to his or her customers or the public; (m) becomes insolvent; (n) files a petition for relief under the bankruptcy laws; (o) does not satisfy a final court judgment against it within thirty (30) days; (p) has a suit filed against it to foreclose any lien or mortgage or garnishments levied and not dismissed within a thirty (30) day period; or (q) any other Franchise Agreement between HRI and FRANCHISEE is terminated in accordance with its terms.

(2) without further action by HRI or notice to FRANCHISEE if FRANCHISEE:

fails to provide accurate reports as required by HRI or fails to make payments of any amounts due HRI for fees, product purchases, Minimum

Purchase Amounts or any other amounts due to HRI, and does not correct such failure within ten (10) days after written notice of such failure is delivered to FRANCHISEE; or

(b) fails to comply with any other provision of this Agreement, the Manual, or any mandatory specification, standard or operating procedures prescribed by HRI and does not: (1) correct such failure within thirty (30) days after written notice of such failure to comply is delivered to FRANCHISEE; or (2) provide proof acceptable to HRI of efforts which are reasonably calculated to correct such failure if such failure cannot reasonably be corrected within thirty (30) days after written notice of such failure to comply is delivered to FRANCHISEE.

14. RIGHTS AND OBLIGATIONS OF HRI AND FRANCHISEE UPON TERMINATION OR EXPIRATION OF FRANCHISE.

*A. PAYMENT OF AMOUNTS OWED TO HRI OR CUSTOMERS.*

FRANCHISEE agrees to pay to HRI within fifteen (15) days after the effective date of termination or expiration of the Franchise, or such later date that the amounts due to HRI are determined, all amounts owed to HRI which are then unpaid. FRANCHISEE further agrees to return to his or her customers all amounts prepaid by such customers within fifteen (15) days after the effective date of termination or expiration of the Franchise.

*B. MARKS.*

FRANCHISEE agrees that upon termination or expiration of the Franchise he or she will: (1) not directly or indirectly at any time or in any manner identify himself or herself or any business as a current or former CHEM–DRY Business, or as a franchisee, licensee or dealer of or as otherwise associated with HRI, or use any Mark, any colorable imitation thereof or other indicia of a CHEM–DRY Business in any manner or for any purpose or utilize for any purpose any trade name, trade or service mark or other commercial symbol that suggests or indicates a connection or association with HRI; (2) return to HRI or destroy all signs, brochures, advertising materials, forms, invoices and other materials containing any Marks or otherwise identifying or relating to the CHEM–DRY Business; (3) take all such action as may be required to cancel all fictitious or assumed name or equivalent registrations relating to his or her use of any Mark; (4) remove all indicia of the Marks from all van(s) not surrendered to or bought by HRI; (5) notify the telephone company and all listing agencies of the termination or expiration of FRANCHISEE's right to use any telephone number and any regular, classified or other telephone directory listings associated with any Mark, and to authorize transfer of same to or at the direction of HRI (FRANCHISEE acknowledges that as between HRI and FRANCHISEE HRI has the sole rights to and interest in all telephone numbers and directory listings associated with any Mark. FRANCHISEE authorizes HRI, and hereby appoints HRI and any officer of HRI as his or her attorney in fact, to direct the telephone company and all listing agencies to transfer same to HRI or at its direction, should FRANCHISEE fail or refuse to do so, and the telephone company and all listing agencies may accept such direction or this Agreement as conclusive of the exclusive rights of HRI in such telephone numbers and directory listings and its authority to direct their transfer); (6) return all materials and supplies identified by the Marks within thirty (30) days after the effective date of termination or expiration of this Agreement; (7) return to HRI all copies of his or her CHEM–DRY Business customer lists; and (8) furnish to HRI, within thirty (30) days after the effective date of termination or expiration, evidence satisfactory to HRI of FRANCHISEE's compliance with the foregoing obligations. FRANCHISEE acknowledges that his or her CHEM–DRY Business customer lists and contracts are derived from and a result of his or her operating a CHEM–DRY franchise. Therefore, FRANCHISEE agrees that such customer lists and contracts may not be used in connection with any business other than the CHEM–DRY Business, and may not be used by, or sold or otherwise transferred to, a third party except as otherwise specifically provided in this Agreement.

*C. RETURN OF EQUIPMENT AND MANUALS.*

FRANCHISEE agrees that upon termination or expiration of the Franchise, he or she will immediately cease to use the Confidential Information of HRI disclosed to FRANCHISEE pursuant to this Agreement in any business or otherwise and return to HRI, at his or her expense, all copies of the Manual for the CHEM–DRY Business that have been loaned to him or her by HRI and all proprietary equipment including any and all Velda HCU units and accessories. All other equipment bearing any of the Marks must either be returned or the Marks must be removed.

*D. COVENANT NOT TO COMPETE.*

Upon termination of this Agreement by HRI in accordance with the provisions of this Agreement, or by FRANCHISEE without cause, or upon expiration of this Agreement (if HRI refuses to grant a successor franchise, as provided in Section 12, or FRANCHISEE elects not to acquire a successor franchise), FRANCHISEE agrees that for a period of three (3) years, commencing on the effective date of termination or expiration, or the date on which FRANCHISEE ceases to conduct the business conducted pursuant to this Agreement, whichever is later, neither FRANCHISEE nor the members of his or her and their immediate families will have any interest as a disclosed or beneficial owner, investor, lender, partner, director, officer, manager, consultant, employee, representative or agent, or in any other capacity, in any Competitive Business located within (1) FRANCHISEE's Franchised Area, (2) ten (10) miles of the boundary of FRANCHISEE's Franchised Area, (3) the franchised area of any other CHEM–DRY Business, or (4) ten (10) miles of the boundary of the franchised area of any other CHEM–DRY Business.

*E. CONTINUING OBLIGATIONS.*

All obligations of HRI and FRANCHISEE which expressly or by their nature survive the expiration or termination of this Agreement shall continue in full force and effect subsequent to and notwithstanding its expiration or termination and until they are satisfied in full or by their nature expire. FRANCHISEE agrees to continue to hold himself or herself responsible for any damages resulting from the operation of the franchise prior to termination or expiration of the Franchise and to indemnify HRI for such damages.

## 15. ENFORCEMENT.

*A. SEVERABILITY AND SUBSTITUTION OF VALID PROVISIONS.*

Except as expressly provided to the contrary herein, each section, paragraph, term and provision of this Agreement, and any portion thereof, shall be considered severable and if, for any reason, any such portion of this Agreement is held to be invalid, contrary to, or in conflict with any applicable present or future law or regulation in a final, unappealable ruling issued by any court, agency or tribunal with competent jurisdiction in a proceeding to which HRI is a party, that ruling shall not impair the operation of, or have any other effect upon, such other portions of this Agreement as may remain otherwise intelligible, which shall continue to be given full force and effect and bind the parties hereto, although any portion held to be invalid shall be deemed not to be a part of this Agreement from the date the time for appeal expires, if FRANCHISEE is a party thereto; otherwise upon FRANCHISEE's receipt of written notice of non-enforcement thereof from HRI. If any covenant herein which restricts competitive activity is deemed unenforceable by virtue of its scope in terms of area, business activity prohibited and/or length of time, but would be enforceable by reducing any part or all thereof, FRANCHISEE and HRI agree that same shall be enforced to the fullest extent permissible under the laws and public policies applied in the jurisdiction in which enforcement is sought. If any applicable and binding law or rule of any jurisdiction requires a greater prior notice of the termination of or refusal to enter into a successor franchise agreement than is required hereunder, or the taking of some other action not required hereunder, or if under any applicable and binding law or rule of any jurisdiction, any provision of this Agreement or any specification, standard or operating procedure prescribed by HRI is invalid or unenforceable, the prior notice and/or other action required by such law or rule shall be substituted for the comparable provisions hereof, and HRI shall have the right, in its sole discretion, to modify such invalid or unenforceable provision, specification, standard or operating procedure to the extent required to be valid and enforceable. Such modification(s) to this Agreement shall be effective only in such jurisdiction, unless HRI elects to give it greater applicability, and shall be enforced as originally made and entered into in all other jurisdictions. FRANCHISEE agrees to be bound by any such modification to this Agreement.

*B. WAIVER OF OBLIGATIONS.*

HRI and FRANCHISEE may by written instrument unilaterally waive or reduce any obligation of or restriction upon the other under this Agreement, effective upon delivery of written notice thereof to the other. Any waiver granted by HRI shall be without prejudice to any other rights HRI may have, will be subject to continuing review by HRI and may be revoked, in HRI's sole discretion, at any time and for any reason, effective upon delivery to FRANCHISEE of ten (10) days prior written notice. HRI and FRANCHISEE shall not be deemed to have waived or impaired any right, power or option reserved by this Agreement by virtue of any custom or practice of the parties at variance with the terms hereof; any failure, refusal or neglect of HRI or FRANCHISEE to exercise any rights under this Agreement or to insist upon exact compliance by the other with Its obligations hereunder, any waiver, forbearance, delay, failure or omission by HRI to exercise any right, power or option, whether of the same, similar or different nature, with respect to other CHEM–DRY Businesses; or the acceptance by HRI of any payments due from FRANCHISEE after any breach of this Agreement.

Neither HRI nor FRANCHISEE shall be liable for loss or damage or deemed to be in breach of this Agreement if its failure to perform its obligations results from: (1) transportation shortages, inadequate supply of equipment, merchandise, supplies, labor, material or energy, or the right to acquire or use any of the foregoing in order to accommodate or comply with the orders, requests, regulations, recommendations or instructions of any federal, state or municipal government or any department or agency thereof; (2) compliance with any law, ruling, order, regulation, requirement or instruction of any federal, state, or municipal government or any department or agency thereof; (3) acts of God; (4) fires, strikes, embargoes, war or riot; or (5) any other similar event or cause. Any delay resulting from any of said causes shall extend performance accordingly or excuse performance, in whole or in part, as may be reasonable, except that said causes shall not excuse payments of amounts owed at the time of such occurrence or payment of fees, Minimum Purchase Amounts or product invoices due thereafter.

*C. INJUNCTIVE RELIEF*

Notwithstanding anything to the contrary contained in Paragraph F of this Section, HRI and FRANCHISEE shall each have the right in a proper case to obtain temporary restraining orders and temporary or preliminary injunctive relief from a court of competent jurisdiction, however, that the parties shall contemporaneously submit their dispute for arbitration on the merits in accordance with Paragraph F of this Section. FRANCHISEE agrees that HRI may have such temporary or preliminary injunctive relief without bond, but upon due notice, and FRANCHISEE's sole remedy in the event of the entry of such injunctive relief shall be the dissolution of such injunctive relief, if warranted, upon hearing duly had (all claims for damages by reason of the wrongful issuance of any such injunction being expressly waived hereby).

*D. RIGHTS OF PARTIES ARE CUMULATIVE.*

The rights of HRI and FRANCHISEE hereunder are cumulative and no exercises or enforcement by HRI or FRANCHISEE of any right or remedy hereunder shall preclude the exercise or enforcement by HRI or FRANCHISEE of any other right or remedy hereunder or which HRI or FRANCHISEE is entitled by law to enforce.

*E. COSTS AND ATTORNEYS' FEES.*

If HRI incurs expenses in connection with FRANCHISEE's failure to pay wh en due amounts owing to HRI, to submit when due any reports, information or supporting records or otherwise to comply with this Agreement, FRANCHISEE shall reimburse HRI for any such costs and expenses which it incurs, including but not limited to reasonable legal, arbitrators', accounting and related fees.

*F. ARBITRATION.*

Except as provided for in Section 1 B of this Franchise Agreement, all controversies, disputes or claims between HRI (its subsidiaries and affiliates, and their respective shareholders, officers, directors, agents, employees and attorneys (in their representative capacity), if applicable) and FRANCHISEE (its employees, if applicable) arising out of or related to:

(1) This agreement or any other agreement between the parties or any provision of such agreements;

(2) The relationship of the parties hereto;

(3) The validity of this Agreement or any other agreement between the parties or any provision of such agreements; or

(4) Any specifications, standards or procedures relating to the establishment or operation of the CHEM–DRY Business

Shall be submitted for arbitration to the Salt Lake City, Utah office of the American Arbitration Association on demand of either party. Notwithstanding the foregoing, any controversies, disputes or claims related to or based on the marks may, at HRI's sole election, be brought and maintained in any court of competent jurisdiction. Such arbitration proceedings shall be conducted in Salt Lake City, Utah and, except as otherwise provided in this Agreement, shall be heard by one arbitrator in accordance with the then current commercial arbitration rules of the American Arbitration Association. All matters within the scope of the Federal Arbitration Act (9 U.S.C. §§ 1 *et seq*. shall be governed by it.

The arbitrator shall have the right to award or include in his or her award any relief which he or she deems proper in the circumstances, including, without limitation, money damages (with interest on unpaid amounts from the date due), specific performance, injunctive relief and attorneys' fees and costs, in accordance with Section 15.E., provided that the arbitrator shall not have authority to award exemplary or punitive damages. The award and decision of the arbitrator shall be conclusive and binding upon all parties hereto and judgment upon the award may be entered in any court of competent jurisdiction. The parties agree to be bound by the provisions of any limitation on the period of time by which claims must be brought. The parties further agree that, in connection with any such arbitration proceeding, each shall submit or file any claim which would constitute a compulsory counterclaim (as defined by Rule 13 of the Federal Rules of Civil Procedure) within the same proceeding as the claim to which it relates. Any such claim which is not submitted or filed in such proceeding shall be barred.

HRI and FRANCHISEE agree that arbitration shall be conducted on an individual, not a class-wide, basis and that an arbitration proceeding between HRI and FRANCHISEE shall not be consolidated with any other arbitration proceeding involving HRI and any other natural person, association, corporation, partnership or other entity.

The provisions of this Paragraph F shall continue in full force and effect subsequent to and notwithstanding the expiration or termination of this Agreement.

*G. GOVERNING LAW*

All matters relafing to arbitration shall be governed by the Federal Arbitration Act (9 U.S.C. §§1 et seq.). Except to the extent governed by the United States Trademark Act of 1946 (Lanham Act, 15 U.S.C.. Sections 1051 et seq.) or other federal law, this Agreement and the franchise shall be governed by the laws of the State of Utah.

*H. JURISDICTION.*

FRANCHISEE agrees that HRI may institute any action against FRANCHISEE (which is not required to be arbitrated hereunder) in any state or federal court of competent jurisdiction in the State of Utah and FRANCHISEE irrevocably submits to the jurisdiction of such courts and waives any objection he or she may have to either the jurisdiction or venue of such court.

1. WAIVER OF PUNITIVE DAMAGES.

Except with respect to FRANCHISEE's obligation to indemnify HRI pursuant to Section 5 of this Agreement, the parties waive to the fullest extent permitted by law any right to or claim for any punitive or exemplary damages against the other and agree that, in the event of a dispute between them, the party making a claim shall be limited to recovery of any actual damages it sustains.

*J. WAIVER OF JURY TRIAL.*

Each party irrevocably waives trial by jury in any action, proceeding or counterclaim, whether at law or in equity, brought by either party.

*K. FRANCHISEE MAY NOT WITHHOLD PAYMENTS.*

FRANCHISEE agrees that he or she will not, on grounds of the alleged nonperformance by HRI of any of its obligations hereunder, withhold payments or amounts due of any kind to HRI.

*L. BINDING EFFECT.*

This Agreement is binding upon the parties hereto and their respective executors, administrators, heirs, assigns and successors in interest and shall not be modified except by written agreement signed by FRANCHISEE and HRI.

*M. LIMITATIONS OF CLAIMS.*

Any and all claims, except claims for monies due HRI, arising out of or relating to this Agreement or the relationship among the parties hereto shall be barred unless an action or legal or arbitration proceeding is commenced within one (1) year from the date FRANCHISEE or HRI knew or should have known of the facts giving rise to such claims.

*N. CONSTRUCTION.*

The preambles and exhibits are a part of this Agreement, which together with the Manual, constitutes the entire agreement of the parties, and there are no other oral or written understandings or agreements between HRI and FRANCHISEE relating to the subject matter of this Agreement. The term "FRANCHISEE" as used herein is applicable to one or more persons, as the case may be, and the singular usage includes the plural. If two or more persons are at any time FRANCHISEE hereunder, their obligations and liabilities to HRI shall be joint and several. The term "CHEM-DRY Business" as used herein includes the Business Assets. The headings of the several sections and paragraphs hereof are for convenience only and do not define, limit or construe the contents of such sections or paragraphs.

Except where this Agreement expressly obligates HRI reasonably to approve or not unreasonably to withhold its approval of any action or request by FRANCHISEE, HRI has the absolute right to refuse any request by FRANCHISEE or to withhold its approval of any action by FRANCHISEE that requires HRI's approval. Nothing in this Agreement is intended, nor shall be deemed, to confer any rights or remedies upon any person or legal entity not a party hereto.

16. NOTICE AND PAYMENTS.

By signing this Agreement, FRANCHISEE certifies that it has received and reviewed HRI's Uniform Franchising Offering Circular along with its Exhibits and this Agreement and its Exhibits ten (10) days prior to signing this Agreement or prior to paying any monies.

All written notices and reports permitted or required to be delivered by the provisions of this Agreement or of the Manual shall be deemed so delivered at the time delivered by hand; one (1) business day after transmission by facsimiles, telecopy, telegraph or comparable electronic system, provided a confirmation copy is sent by a commercial courier service for next business day delivery; one (1) business day after being placed in the hands of a commercial courier service for next business day delivery; or three (3) business days after placement in the mail by Registered or Certified Mail, Return Receipt Requested, postage prepaid, to the address set forth herein, or to such other address as designated in writing by HRI or FRANCHISEE. Any required payment or report which HRI does not actually receive at the correct address during regular or business hours on the date due (or postmarked by postal authorities at least two (2) days before it is due) will be deemed delinquent.

*IN WITNESS WHEREOF*, the parties hereto have executed, sealed and delivered this Agreement in multiple counterparts on the day and year first above written.

FRANCHISEE Individually and Personally

FRANCHISEE Individually and Personally

*HARRIS RESEARCH, INC.*

By:
Brent D. Mortensen
Title: CORPORATE SECRETARY

RELEASE AGREEMENT—RENEWAL/CALIFORNIA

*THIS RELEASE AGREEMENT* is made and entered into this ________ day of __________ 19-____, by and between HARRIS RESEARCH, INC., a Utah corporation ("HRI") and ______________________________ ("Franchisee").

*WITNESSETH:*

WHEREAS, HRI and Franchisee entered into that certain Franchise Agreement dated the _______ day of '19-_________ (the "Franchise Agreement'), whereby Franchisee was granted the right to own and operate a CHEM-DRY business within the following area,

WHEREAS, the Franchise Agreement expires on the _______ day of ____ 19-__________;

WHEREAS, Franchisee desires to acquire a successor franchise for an additional term of five (5) years; and

WHEREAS, HRI is willing to grant a successor franchise to Franchisee provided Franchisee meets the requirements of Section III of the Franchise Agreement, including but not limited to executing this Agreement concurrently with the execution of a new franchise agreement and payment of the renewal fee of Five Hundred Dollars ($500.00) to HRI.

NOW, THEREFORE, in consideration of the covenants contained herein and other good and valuable consideration, the receipt of which is hereby acknowledged, the parties hereto agree as follows:

1. Release. The Franchisee hereby forever releases, remises and discharges HRI and HRI's affiliates, its shareholders, directors, officers, employees and agents, and all its respective heirs, executors, administrators, successors and assigns, of and from any and all known and unknown claims, causes of action, suits, debts, agreements, promises and demands of whatever nature or kind, in law or in equity, other than those arising from this Agreement, which the Franchisee now has, ever had, or, but for this release, hereafter would or could have relating in any manner to the Franchise Agreement. Franchisee hereby warrants and represents to HRI that he or she has not assigned any of the above-described claims, causes of action, suits, debts, agreements, promises and demands released hereunder.

The Franchisee acknowledges that this Release Agreement is a general release which extends to all known and unknown claims, causes of action, suits, debts, agreements, promises and demands whether or not claimed or suspected. The Franchisee waives all of the provisions of California Civil Code Section 1542. and similar laws of other jurisdictions. California Civil Code Section 1542 reads as follows:

"A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

*2. Construction and Enforcement*

(a) *Governing Law*. Except to the extent governed by the United States Trademark Act of 1946 (Lanham Act, 15 U.S.C. Sections 1051 *et seq.*), this Agreement shall be governed by the laws of the State of Utah.

(b) *Binding Effect* This Agreement is binding upon the parties hereto and their respective executors, administrators, heirs, assigns and successors in interest, and shall not be modified except by written agreement signed by Franchisee and HRI.

(c) *Construction*. The preambles are a part of this Agreement, which constitutes the entire agreement of the parties relating to its subject matter. The headings of the several sections and paragraphs hereof are for convenience only and do not define, limit or construe the contents of such sections or paragraphs.

*IN WITNESS WHEREOF*, the parties hereto have executed this Release Agreement as of the date first above written.

FRANCHISEE

Individually & Personally

*HARRIS RESEARCH, INC.*

By: Brent D. Mortensen
Title: Corporate Secretary
UFOC9810 OCT

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TRICON GLOBAL RESTAURANTS, INC.,
*Louisville, KY, June 28, 1999.*

Hon. GEORGE GEKAS, *Chairman,*
*Subcommittee on Commercial and Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: Tricon Global Restaurants is the parent company of Pizza Hut, Taco Bell and KFC. It has come to our attention that a former Taco Bell franchisee, Darrell Dunafon, testified before your committee last week, reporting what he felt was unsatisfactory treatment by his franchisor.

On review of Mr. Dunafon's testimony we were concerned by a number of misstatements both in tone and in fact. The debate on franchise relationship legislation was addressed by all panels during last week's hearing. I'll therefore limit our comments to specifics raised by Mr. Dunafon. I ask that this letter be made part of the written record of the hearing.

As background, Tricon was formed in September of 1997 as a spin-off of the restaurant divisions of PepsiCo, Inc. Tricon and our franchise partners operate some 30,000 units worldwide. Of these, 72% are franchise owned and operated. That percentage has increased dramatically under Tricon management; our goal is to further grow franchise ownership to 80% of our systems.

With our franchisees in the U.S., we jointly formed a purchasing co-op to supply both franchise and company owned stores. Our systems are jointly governed with our franchisees including products, sales strategies and advertising. We believe Tricon's franchise relationships are thriving.

Mr. Dunafon reports a somewhat skewed viewpoint of the circumstances in the Taco Bell system during his tenure as a franchisee.

Taco Bell's contract with our franchisees has always reserved the right to decide when and where a franchisee may build new units. Such control is necessary to assure orderly growth in the system. These provisions were part of Mr. Dunafon's franchise agreement since day one.

Mr. Dunafon claims he was denied the right to expand because of his leadership of the now disbanded International Association of Taco Bell Franchisees. The IATBF was formed by some of our Taco Bell Franchisees to pursue new contract accords with the parent company. Initially, discussions were difficult, but in time, reasonable people on both sides agreed to work out our differences in private negotiations. The membership of IATBF agreed to follow this strategy.

In spite of the decision by his fellow franchisees, Mr. Dunafon continued to make public and legal attacks on Taco Bell Corporation. In media interviews he made unfounded accusations of criminal and illegal acts. He made unsubstantiated claims of product quality and food safety problems. He publicly attacked management as incompetent and untrustworthy.

While Taco Bell successfully worked to satisfy the concerns of our franchisees, Mr. Dunafon continued to agitate and slander. IATBF ceased existence not, as Mr. Dunafon claims due to a lack of leadership, but because issues were settled amiably and there was no further need for the Association.

It is beyond our understanding why, if Mr. Dunafon felt so negatively toward Taco Bell, he would want to expand his business relationship. However, in light of his continued hostility, Taco Bell denied his expansion proposals.

It is important to note that at no time did Taco Bell take any action to threaten Mr. Dunafon's existing business. We honored his contracts to the letter. We made a simple decision not to allow him to open new units. Expansion rights were never part of his contract nor implied in any discussions or in writing.

Mr. Dunafon's immediate response was to file a lawsuit. Mr. Dunafon stated in his testimony that Taco Bell refused to enter mediation of his complaints. Taco Bell's initial refusal to proceed to mediation was based solely on Mr. Dunafon's active pursuit of litigation. In fact, Mr. Dunafon's case eventually did go to mediation on two separate occasions, but Mr. Dunafon refused to settle until advised by the trial judge to do so.

Taco Bell always tries to compromise disputes with its franchisees. Mr. Dunafon simply refused to discuss settlement until told to by the court.

Mr. Dunafon inherited his business from his father. His brother, who inherited the other half of the business, remains with the Taco Bell system and now operates over 30 units. Other franchisees formerly involved in IATBF have grown and profited from their continued affiliation with Taco Bell. Our relationship with our franchisees has never been stronger.

In the end Mr. Dunafon was able to sell his Taco Bell units to another franchisee at a substantial profit and continues to draw income from real estate leases on several of his former locations. While Mr. Dunafon finds his Taco Bell experience unsatisfactory, he is now a multi-millionaire because of it.

Tricon has ongoing business partnerships with literally thousands of franchisees. While problems in business relationships are on occasion unavoidable, the level of distrust and hostility directed at Taco Bell in its relationship with Mr. Dunafon is very rare—if not unique. Taco Bell and Tricon are dedicated to building the highest level of cooperation and trust between the company and our franchisees. Our business will grow and profit only as our franchise partners succeed.

Thank you for your interest. If you or your staff have any further questions, please contact me.

Sincerely,

WILLIAM J. EHRIG, *Senior Director,*
*Government Affairs.*

DICKINSON, MACKAMAN, TYLER & HAGEN, P.C.,
ATTORNEYS AND COUNSELORS,
*Des Moines, IA, June 29, 1999.*

SUSAN JENSEN-CONKLIN, *Counsel,*
*Subcommittee on Commercial and Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR MS. JENSEN-CONKLIN: I understand that the Subcommittee on Commercial and Administrative Law held a hearing on June 24, 1999 related to the need for legislation establishing standards of conduct for franchisors. I ask that this letter be included as part of the written record of the June 24, 1999 hearing.

I am a licensed attorney in the State of Iowa who has represented the Iowa Franchisee Association and individual franchisees in franchise related matters. As you know, in 1992 Iowa enacted the Iowa Franchise Act, which provides certain protections to franchisees. The legislation was enacted after the Iowa General Assembly held hearings demonstrating abuses that were occurring in the franchise arena.

When the legislation was being considered, opponents argued that it would increase litigation. Grave warnings were issued about the heavy burdens of litigation that would inevitably result, and the law was declared to be a "lawyers relief act" to stir anti-lawyer sentiment. In Iowa, however, there has been no litigation explosion. Indeed, while the Iowa Franchise Act was passed in 1992, there is still not one reported appellate case in the Iowa state courts under it, and the only reported federal court case is an action that was brought by franchisors challenging the constitutionality of the measure.

Another argument advanced by the franchisors has been that economic harm would result in Iowa. Indeed, some franchisors a few years ago attempted to organize a boycott of Iowa, not because the statute was unworkable, but to attempt to gain political leverage with the state legislature, a heavy handed approach that backfired. The lists of boycott participants which circulated at the time included systems that had no market in Iowa as well as systems who were in fact opening new outlets. The attempted boycott, which never had material economic impact, was always a paper tiger, has now completely collapsed, and franchising continues to be alive, well, and expanding in Iowa.

The Iowa legislation has been very helpful in defining the relationship between franchisors and franchisees. It has done exactly what it was intended to do, namely, provide a modicum of protection against the worst abuses in franchising without impairing the ability of the franchisor to maintain system quality. It has not led to a litigation explosion or crippled economic development. I strongly endorse the efforts to obtain similar protection for franchisees on a nationwide basis.

Sincerely,

BRENT R. APPEL.

cc: Susan Kezios, American Franchise Association

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PREPARED STATEMENT OF STEVE LEWIS, PRESIDENT, NATIONAL FRANCHISEE ASSOCIATION

Mr. Chairman, my name is Steve Lewis. I am the President of the National Franchisee Association, Inc. (NFA). The NFA is the officially recognized trade association and public voice of more than 1,200 Burger King® restaurant franchise owners, which in turn operate more than 8,000 Burger King® restaurants in virtually every community across our great nation, and employ more than 250,000 teenagers and adults from every walk of life.

It is, therefore, with significant interest that we submit our comments today to this Oversight Subcommittee hearing on the current state of commercial/retail franchising in the United States.

Franchising as a means of promoting a brand or specialized service is certainly not a new business concept, and of course, is widely accepted as a benefit to consumers and entrepreneurs alike.

Yet, no one envisioned the extent to which franchising—as a means of providing new business opportunities and meeting growing consumer needs—would grow. Today, more than 80% of America's retail business is transacted through franchises or related concepts. In fact, chain franchising has all but eliminated the historic "mom and pop" type businesses.

Or have they? "Mom and pop" operations have not really disappeared—they are very often *franchisees* of the various food, goods and services franchise concepts where America shops. It is their time and money, which, in most cases, establishes the identity of the franchised concept throughout the country—their labor and "sweat equity" creating the "goodwill" of the Brand with the consumer. In fact, frequently it is the franchisee's life savings and good credit, combined with personal sacrifices of 7-day work weeks, lost family time, and vacationless years that contribute significantly to the value of a brand.

The simple truth is that *these* moms and pops pay to hang a fancier, more commercially-recognized shingle over their businesses. But everything else historically associated with the American small business person is as it was, with the exception that in today's competitive business environment, relying singularly on one's own self reliance does not provide the best opportunity for success. Hence the role of the franchisor.

The NFA recognizes the very important role a good franchisor plays in the success of a brand. At the inception of franchising, disclosure of services and financial representation were of major concern to prospective franchisees and to those government agencies most concerned with commerce.

There are a number of brand concepts such as Burger King® which, quite honestly, started with the proverbial handshake and "napkin contracts". It was an honor to the franchisor that someone would believe in his or her idea, invest savings in the business concept, and more importantly, join the franchisor as a partner—working, borrowing, building and investing to advance the growth and return on the franchisor's idea. And, it was a uniquely American concept to expand a brand using someone else's capital and time.

But the world is not the same now as it was when franchising began. Like the pioneers who crossed the Great Plains, the franchisor thought the world plentiful, and growth to be limitless. The partners drawing their wagons were critical to the success of their endeavor, and when treated fairly were happy in the journey. When brand teams acted in each other's best interests, their brands grew, prospered and contributed to breakthrough ideas in products, services and advertising. The team provided job growth and personal enrichment for all parties; the need for rules governing the relationship between them was minimal.

Yet the world did not foresee that 80% of all retailing would be funneled through franchise arrangements or the involvement of corporations larger and grander than the railroad and oil monopolies of years past. Nor did it foresee that unfriendly takeovers, mergers and competition for shareholders' dollars would reshape the brand partnership and reduce it to one where the franchisor could undervalue the personal contributions of the franchisee, viewing the franchisee only as a mere profit opportunity.

Today's franchisor enjoys almost unlimited freedom in its business dealings with its franchisees:

- Contracts, ostensibly written as "documents to protect the brand", can serve as one-sided vehicles to satisfy the franchisor's inordinate profit motives by wresting the franchisees' hard-won economic value from them. The spirit of partnership is rekindled only when the franchisees are willing to stand up and assert that they, like other citizens, should enjoy the full protection of our legal system.
- Legal advice suggests that a "contract" imposes an obligation on all involved parties to exercise good faith and fair dealing. But franchisors' are aided in suppressing "good faith and fair dealing" in disputes with their franchisees, by way of legal decisions, which reflect an outdated and narrow regulatory view toward this obligation. Those decisions essentially allow franchisors to write this obligation out of the contract.
- Franchisees are frequently denied the right to be heard in their own business venue and are unfairly pushed into bad business decisions with economic threats to their personal livelihood.
- In an arbitrary fashion comparable to the "monopolistic barons" of the industrial era, the franchisor can, through its exercise of its right of "sole discretion", devalue franchisees' financial worth, reducing years of faithful, hard work and earned "goodwill" significantly. In fact, most franchisors have the ability to exercise a "right of first refusal" to acquire the franchisee's business, a fact not lost on the franchisee when the business has been artificially devalued by the franchisor.
- The franchisee, on the other hand, has few to no rights to negotiate these policies and to date little in the way of legal redress.

Physical growth by location is a primary objective of the franchisor, and one which is financially rewarding. With the franchisee as the growth vehicle, the franchisor benefits from reduced capital outlay and corporate labor, added revenue from top-line sales, and substantial, up-front cash fees. Profit projections and plans are many times dependent on this type of "new growth". As referenced earlier, the "Great Plains" mindset offered plenty of room in the beginning. However, with the maturation and saturation of many types of services and concepts, the franchisor's physical and financial growth has come at the expense of "same brand" established locations, usually operated by existing franchisees.

A brand encroaching upon itself has a severely damaging impact—perhaps the most damaging within the brand system. In many instances, sales at existing locations are substantially reduced, affecting both profitability and the ability to enjoy the benefits already derived from an existing franchisee's hard work and equity. Sometimes it forces the franchisee to sell at a loss or just to walk away. The franchisor, while promising to use care and due diligence when selecting new locations, especially in evaluating their impact on an existing location, has no incentive to protect existing franchisees. There are times that honest mistakes or miscalculations are made, but there are many times that the desire to realize the development fees and meet profit expectations supersede the potential impact to an existing franchisee.

Attempts to prevent or, at the least, delay the process to review the facts, are viewed by the franchisor as detrimental, casting the objecting franchisee as disloyal to the brand and in need of corrective action. When such a disagreement persists, the affected franchisee finds no fair legal remedy available—the franchise agreements designed to "protect the brand" rarely, if ever, offer any solution to the impacted franchisee. The franchisor is neither held to the standards of, nor accountable to, any court for failure to practice "good faith and fair dealing" with its respective franchisees. The courts continue to view the Franchise Agreement only in the narrow light of a contract, and are bound to this approach *until and unless* state or federal legislative bodies, such as this Subcommittee, find time to evaluate the practices of franchisors and incorporate the concept of "good faith and fair dealing" into that evaluation.

Franchisees supporting a brand by executing the franchisor's operating and other reasonable standards should not be "bullied" into quietly accepting the devaluation of their hard won financial worth and the enjoyment of the rewards provided by developing the value of "goodwill" at their location.

Another impact of the franchise agreement, not anticipated during the inception of this industry, was the right to renew or continue to operate as a specific brand once the initial franchise term expired. As franchising evolved from close partnerships to the dominant means of retail business, the contracts evolved as well. Originally, the idea was that the franchisor needed flexibility in the contract to ensure brand protection. Additionally, the franchisor found it too burdensome and costly to expunge "poor operators" from its systems. Therefore a "term limit"—a fixed contract period—was a tool to accommodate this effort, simplifying the process so that "bad operators" would not be renewed.

But, this concept evolved as well. Today a franchisee may find himself or herself in compliance, with a good pay record, and may have been viewed as a friend of the brand over the years. Yet, franchisor management turnover, mergers with other companies and other major management changes can leave the franchisee essentially alone in the knowledge of his or her historical contributions. Worse yet, after building up sales and profits over 15 to 20 years, the franchisee may find the "new franchisor team" no longer values the franchisee's historical contributions or flawless performance record, valuing instead the "economic value" of the business the franchisee has built. Frankly, the franchisor can choose not to renew the license and assume the business location at or about the same vicinity, and immediately enjoy the franchisee's 15 to 20 years of "sweat equity". Or, the franchisee might try and sell in an effort to realize some value, albeit reduced value since their contract time is up. Again, the franchisor can buy the location at reduced value.

Other actions that can and have added to the difficulty of the franchisee-franchisor relationship involve unilateral increases in such basic costs of doing business as the franchise royalty rate, rent and the annual advertising contribution. Such increases usually involve a substantial reinvestment of capital into the business, which could, in essence, affect the economic viability of the franchise operation. Compounding the effect of these increases, which often include large ticket items, is the lack of economic justification or substantiation provided to the affected franchisee.

Adding to this lopsided relationship is the fact that most contracts have language prohibiting the franchisee from engaging in a similar—not same, but similar—business in the vicinity, thereby not even being able to profit from his or her 15 to 20 year personal knowledge of the community. The logic behind this explanation is that if, as part of the franchisor's concept, for example, you changed tires, you would be exercising skills you learned from the franchisor ("trade secrets") if you attempted to start your own tire-changing business in the vicinity of the franchisor's brand. Additionally, you would be competing unfairly, using the skills that the franchisor taught you, while not compensating the franchisor for those skills.

There are other aspects of the franchising relationship that need to be examined, as part of your inquiry and it is probable that other "like minded" groups will also shed more light upon those areas.

In closing, we want to address criticism that circulates whenever franchisees attempt to address the inadequacies of existing oversight in the franchising industries. Primarily that franchisee's *choose* not to make sufficient effort to address the types of issues outlined in this testimony with their respective franchisors.

The NFA, as a result of a large international concern buying our brand franchisor, faced a substantial reduction of management services historically provided by the franchisor. Which in turn significantly devalued our investments in the brand. Leaving us no recourse but to confront and demand a change by the "new management" in their approach to our business.

After making numerous and significant efforts to correct the "new management's" approach, with little result, we pursued a legislative remedy. The result being the franchisors management seeking rapprochement, agreeing to discussions, policies and procedures in an effort to "deal fairly" with the issues previously advanced. Initially progress was made and as in the beginning, "the partnership" assured positive momentum, sales improved, growth was managed "better" than before, and a process to address issues was made available.

Management changes now and in the future threaten the relationship and the "economic value" of our franchise businesses. The profit needs of the franchisor casts a shadow on "good faith and fair dealing ". Encroachment and renewal policies are redesigned to meet management profit goals and incentives at the expense of faithful and loyal veterans of the brand. Harmful, arbitrary policies aimed at hardworking and honest "moms and pops", can be implemented with little to no protection available to those who are unfairly affected.

Franchisees should not have to continue to put their families, their futures, and themselves at risk every time a takeover occurs or whenever a franchisor management team changes. They are not employees. They are not indentured servants. They are the investors, the local taxpayers, the families, and the same American "moms and pops" who deserve a reasonable level of protection in their home states, including access to the courts, if necessary. We believe in right and wrong. We believe in entering all business relationships from the perspective of "good faith and fair dealing". Who could be against that?

Mr. Chairman, the NFA commends you on holding this oversight hearing on franchisor-franchisee relationships. We hope we have provided insightful and helpful comments regarding the topic of this hearing. We are also hopeful that you can find your way to help franchising evolve and allow us—the franchisees—to enjoy the right to "good faith and fair dealing" in our business arrangements with our franchisors.

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WITMER, KARP, WARNER & THUOTTE LLP,
COUNSELLORS AT LAW,
*Boston, MA, July 1, 1999.*

Hon. GEORGE W. GEKAS, *Chairman,*
*Subcommittee on Commercial and Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: I was present at the hearing of the Subcommittee on Commercial and Administrative Law which you conducted this past Thursday, June 24, 1999. I very much appreciate this opportunity to submit this letter and the accompanying materials to supplement the written record of that hearing.

I am a franchise attorney who represents franchisees and franchisee associations. I have represented clients in the following franchise systems: McDonalds, Little Caesars Pizza, Domino's Pizza, Pearle Vision, Ben & Jerry's, 7-Eleven, SpeeDee Oil Change & Tune Up, Pepperidge Farm, Better Homes and Gardens, Prudential Real Estate, Johnny Rockets, California Closets, H&R Block, Jackson Hewitt Tax Service, Great Clips and many more.

I am a Director of the American Franchisee Association (AFA). I served as the Chair of the 1999 AFA Franchisee Legal Symposium.

In June, 1994, 1 testified before the U.S. House Small Business Committee on "Self Regulation of Franchising: The IFA Code of Ethics." An elected delegate to the 1995 White House Conference on Small Business, I have twice testified before the Joint Committee on Commerce and Labor of the Massachusetts Legislature on franchise issues. Since 1996, 1 have served on the Advisory Committee of the Franchise and Business Opportunities Committee of the North American Securities Administrators Association.

*A. Franchise agreements are grossly and unconscionably one-sided and presented on a take it or leave it basis.*

During the hearing, there was some discussion about the extent to which franchise agreements are the results of a true meeting of the minds or whether they generally constitute contracts of adhesion.

This year, we conducted a first of its kind comprehensive comparison study of the Franchise Agreements and Franchisee Offering Circulars of the top eight pizza chains in the United States.

The study was first released to the public at the AFA's 1999 Franchisee Legal Symposium held May 6–7 at Hilton Head, South Carolina under the title: "Holding A Gun To Your Head: Marketplace Monopoly-How Pizza Franchisors Play The Game". Dr. Frank Wadsworth, Assistant Professor of Marketing at Indiana University Southeast, provided a foreward. A copy of the Pizza Study is enclosed.

We undertook this study in part because in my practice we often hear what more than one of the IFA-sponsored witnesses stated at the hearing last week: *nobody held a gun to the head* of a prospective franchisee, compelling him or her to sign a franchisee agreement. Implicit in this overworked phrase is the assumption that the marketplace has created meaningful choices for franchisees who seek a franchise relationship marked by a fair balance of financial and legal rights, responsibilities and rewards. The Pizza Study tells us that this assumption is false.

The top eight pizza franchisors, whose sales exceed $10.7 Billion per year, control over one third of the entire ready to eat pizza market. They sell a combined One Billion pizzas per year. About 65% of their locations are franchised. Collectively, they account for 85% of the sales of the top 27 franchised pizza chains. This means that the top eight wield enormous market power, functioning as a *de facto* monopoly in the presentation of franchise contract terms.

The franchise agreements offered by the top eight pizza franchisors are remarkably and disturbingly similar in content. Three themes permeate the agreements studied: unbridled discretion in the hands of the franchisor, unlimited calls on the franchisee's capital, and asymmetry of the rights and obligations of the two parties.

*Unbridled Discretion*—The majority of the franchisors' purported obligations must only be provided if and to the extent the franchisor deems, in its sole discretion, appropriate. Thus, very little is, in fact, promised. In addition, each reserves the right to unilaterally modify its operations manual, from which the franchisee receives the majority of its marching orders and with which the franchisee must always comply.

*Unlimited Calls on Capital*—The ongoing investment that may be required of the franchisee is limitless. All of the top eight pizza franchisors reserve the right to restrict suppliers, potentially creating captive customers in its franchisees. They all reserve the right to change the very essence of the business, their trademarks and none compensates its franchisees for lost revenues due to resulting customer confusion or dissatisfaction. Moreover, five of the top eight require that the franchisee pay for of all new signage, products, advertising, and the like.

*Asymmetry of Rights*—Examples include the franchisor's unrestricted right to assign its interest in the agreement compared to the franchisee's heavily restricted right; the franchisor's right of first refusal with respect to sale of the franchised business compared to the absence of a right of first refusal for franchisees on the purchase of new restaurants the franchisor intends to open; the unilateral right of the franchisor to litigate any matter arising out of the contract in a designated location of its choice and under a designated law of its choice; and the requirement that the franchisee indemnify the franchisor for all claims of negligence against the franchisee without any reciprocal obligation on the part of the franchisor.

The top eight pizza franchisors have attained pervasive and unilateral control over franchise terms and conditions, with unheard of bargaining and negotiation power rarely seen outside the world of franchising.

Furthermore, based on my experience as a franchisee attorney, it does not matter whether the franchise offered involves the sale of pizza, hamburgers, eye glasses or tax preparation services, the same kind of take-it-or leave-it, non-negotiable and grossly one-sided agreements are the norm.

A generation ago, Congress recognized that gas station owners and automobile dealers were being victimized by a gross concentration of power in the oil companies and auto manufacturers. Indeed, the Preamble to the Auto Dealers Day in Court Act is as follows:

> AN ACT to supplement the antitrust laws of the United States, *in order to balance the power now heavily weighted in favor of automobile manufacturers*, by enabling franchise automobile dealers to bring suit in the district courts of the United States to recover damages sustained by reason of the failure of automobile manufacturers to act in good faith in complying with the terms of franchises or in terminating or not renewing franchises with their dealers (emphasis supplied).

The very same imbalance of power that Congress found in 1956 in the automobile industry and in 1978, when it enacted similar protections for gasoline station owners, exists today but on an even greater scale with respect to the franchising in general.

The Pizza Study demonstrates the impact of that imbalance and that few real alternatives exists. If a franchisee wants to open a pizza store that will be recognized by the general public, it must contract with one of the top eight franchisors. Among those top eight there is little meaningful variation in the terms of the franchise agreements offered.

These observations lead inexorably to the conclusion that a national standard governing the franchise relationship is necessary as a means of leveling the playing field on which franchisors and franchisees contract.

*B. The enactment of a Bill similar to HIR 4841 would not add to but would rather reduce the amount of litigation in the United States.*

One simple example is the venue provision of the Bill which states that any provision in a franchise agreement that prevents a franchisee from litigating in his or her home state is void.

The fact is that many hundreds of thousands of dollars of legal fees are consumed every year in fiercely contested litigation over where the ligation should take place. These efforts must be concluded before the parties can address the merits of the dispute.

The reason for this problem is the lack of a clear, unequivocal national standard on the issue of so-called venue clauses.

Venue clauses are deemed so highly prejudicial to the franchisee that the UFOC Guidelines require that they be listed as a separate Risk Factor at the front of the UFOC.

Here is what the New Jersey Supreme Court had to say in 1996, in a decision invalidating forum selection clauses in franchise agreements-provisions which require all litigation to be conducted in the home state of the franchisor:

> *At the contract stage, the franchisor typically submits a standard contract and, depending on the potential value and profitability of the franchise, a franchisee may elect not to test the negotiability of terms of the contract to avoid the risk of antagonizing the franchisor and losing the franchise. In that setting, a franchisor has little to lose by including a forum-selection clause in its standard agreement. Although such a clause directly benefits the franchisor by requiring suit to be filed in a geographically convenient state of choice where it can be defended by the franchisor's regular litigation counsel, the indirect benefit to franchisors is to make litigation more costly and cumbersome for economically weaker franchisees that often lack the sophistication and resources to litigate effectively a long distance from home.*
>
> *Kubis & Perszyk Associates, Inc.* v. *Sun Microsystems, Inc.*, Business Franchise Guide (CCH) ¶10,980 (July 23, 1996).

For these reasons of fundamental fairness, California, Illinois, Iowa, South Dakota and Rhode Island all have franchise statutes that make venue clauses void.

In addition, the Uniform Franchise and Business Opportunities Act as approved by the National Conference of Commissioners on Uniform State Laws in 1987, and the Model Franchise Investment Act adopted by the North American Securities Administrators Association in 1990, would both make venue clauses unenforceable.

It is time to make this a national standard. With such a rule in place, litigation over the place of litigation will cease.

Another example of this principle is the transfer provision of HR 4841. These provisions provide some basic and clear-cut rules for how the process of the sale of a franchise business should unfold. The proposed rules strike a fair balance between the right of the franchisee to realize the equity built up in the business through his or her capital investment and hard work with the right of the franchisor to exercise reasonable control over the qualifications of franchisees in its system. The proposed bill closely resembles Section 6 of the New Jersey Franchise Practices Act of 1971.

With the enactment of this section of HR 4841, both parties to the franchise agreement will have a clear and easy to follow set of minimum standards for processing a transfer of a franchise. With each party having the benefit of knowing what is expected by the other, there will be fewer disputes and less, not more, litigation.

HR 4841 is replete with these kinds of provisions, each of which is designed to reduce the amount of friction between franchisor and franchisee. Far from being a boon to lawyers, it will in fact keep the parties out of court more often than our current hodgepodge of inconsistent state laws which creates a vacuum leading to disputes and litigation.

*C. The Freedom of Sourcing*

HR 4841 would allow franchisees to purchase goods and supplies used in the franchise business from any source provided they meet the system-wide quality standards of the franchisor.

Contrary to some of the testimony at the hearing, this provision would not undermine the legitimate need of the franchisor to insure quality and uniformity in the franchise system. By setting themselves up as the sole supplier of not only food products but such items as uniforms and paper goods, many franchisors have created an extra level of profit which artificially inflates the franchisee's costs. The ultimate burden of these increased costs falls to millions of consumers at the point of sale.

The argument by franchisors, that freedom of sourcing would undermine system standards is nothing short of a red herring. It is designed to hide the fact that franchisors seek to reap hidden kickbacks and profit at the expense of the franchisees and their customers.

Indeed, a research report issued by Bear Stearns on March 12 of this year concerning Choice Hotels, Inc., a publicly held lodging franchisor, stated as follows:

> *Choice has what many product and service providers covet—a large captive base of potential customers, represented by its guests in addition to its franchisees.*
>
> *The opportunities to create incremental cash flows by charging product and service providers for access to these groups is virtually limitless, in our opinion. Generally, there a few costs associated with these efforts and most of each incremental dollar in revenue generated falls directly to the bottom line.*
>
> *Choice expects to generate nearly $15 Million from these activities in 1999 and nearly $17 Million in 2000.*

Note that these "access fees" are projected to amount to almost 10% of the franchisor's revenue from all sources. On the assumption that the goods and service providers are for-profit entities, there is little doubt that these "access fees" will translate into higher costs for Choice Hotel franchisees and their guests.

Thank you for this opportunity to present my views on the important subject of franchising in the United States, which as you stated in your opening remarks, touches the lives of nearly every American.

We hope Congress will give early and favorable consideration to these legislative proposals.

Very truly yours,

ERIC H. KARP.

Enclosures

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ROSEN, EINBINDER & DUNN, P.C.,
ATTORNEYS AT LAW,
*New York, NY, July 1, 1999.*

SUSAN JENSEN-CONKLIN, *Counsel,*
*Subcommittee on Commercian and*
*Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

Re: *June 24, 1999 Oversight Hearing on Franchising*

DEAR MS. JENSEN-CONKLIN: I am writing with respect to the June 24, 1999 Oversight Hearing on Franchising and ask that this letter be included in the written record with respect to the hearing.

This firm represents franchisees in transactional matters and in litigation. I have personally been practicing in the franchise field for over 10 years.

There are fundamental flaws in franchising as a basic structure. Many of my clients come to me after disputes have arisen with their franchisor concerning territorial issues or unfair practices that have affected their revenues and profitability. The inherent conflict between franchisor and franchisee cannot be addressed solely by market forces. Rather, legislation is needed to address these imbalances. Indeed, all of my clients would benefit greatly from the proposed legislation.

As you know, franchisors provide a limited time frame within which a franchisee can maintain its business operation. As the end of the term of the franchise agreement approaches, numerous conflicts arise. Franchisors routinely impose more restrictive terms in the franchisees' renewal agreements. In many cases, these terms significantly decrease the value of their businesses. For example, an existing franchise agreement may provide for an exclusive territory while the renewal agreement will not allow for any exclusive territory whatsoever. This is an arbitrary decision on the franchisor's part. There is no negotiation!

Furthermore, franchisors routinely engage in unfair practices. For example, we have had numerous clients who have paid substantial sums of money to franchisors for advertising and found that the advertising funds have been dissipated or used by the franchisor for its own purpose or to promote its own stores, or worse, the sale of franchises, instead of to promote all of the franchisees' businesses. There is no question that a franchisor should have at least a limited fiduciary duty when handling franchisee money, whether it is for advertising funds or rebates obtained by the franchisor in connection with the franchisees' wholesale acquisition of products.

I strongly urge that this proposed legislation be enacted.

Very truly yours,

MICHAEL EINBINDER.

Enclosures
cc: Susan Kezios

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LAW OFFICES HELLER KAPUSTIN
GERSHMAN & VOGEL,
*Blue Bell, PA, July 1, 1999.*

Hon. GEORGE W. GEKAS,
c/o SUSAN JENSEN-CONKLIN, *Counsel,*
*Subcommittee on Commercial and*
*Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

RE: *House Judiciary Committee's Subcommittee on Commercial and Administrative Law Oversight Hearing on Franchising, June 24, 1999*

DEAR CONGRESSMAN GEKAS AND MS. JENSEN-CONKLIN: I hereby request that this letter be made a part of the official written record for the June 24, 1999 Oversight Hearing on Franchising held before Chairman George W. Gekas.

On June 24, 1999, I attended the House Judiciary Committee's Subcommittee on Commercial and Administrative Law Oversight Hearing on Franchising. Accordingly, I wish to respond to some of the testimony that was presented to the committee.

First, I am an attorney with offices in Pennsylvania, New Jersey and South Carolina. I primarily represent franchisees in all aspects of franchising, including, but not limited, to advising prospective franchisees as to the Uniform Franchise Offering Circular, the franchise agreement and related documents, establishment of the franchise business, day to day operations and, unfortunately, dispute resolution matters. Accordingly, I have the opportunity to represent franchisees from start to finish.

The concerns of franchisees are real. My clients and the franchisee community at large would do nothing but benefit from Federal legislation such as that which was proposed in H.R. 4841 before the 105th Congress. No one, including myself and franchisees, desires for the Federal government to be involved in day to day business operations unless all else has failed. Unfortunately, when there are wide spread abuses, there are at times no alternatives. The franchisee community has *no choice* but to ask Congress to enact certain standards of fairness for the franchise relationship.

Let me make it clear, that all franchisors are not abusive. Conversely, all franchisees are not saints. However, when it comes to public protection we deal with issues of whether there are wide spread abuses and whether it is affecting a large number within that certain class to be protected and those to be protected do not have the power to protect themselves. In this case we have that.

Entering into a franchise agreement is not like entering into any other type of business arrangement. As was stated in the testimony, in order to compete in a variety of industries, the "only game in town" is to be a franchise. The power of brand recognition is beyond belief. I know that simply from having my children tell me where we should eat or what to buy simply because of brand recognition. The independent business owner is in jeopardy and has been as a result of franchising.

I know that in my practice I have attempted on behalf of my clients to negotiate for the terms and conditions that are being proposed by the franchisee community in connection with HR 4841 and other proposals in favor of franchise legislation. Unfortunately, the vast majority of franchisors have refused to negotiate or amend their franchise agreements with respect to the proposed issues, i.e. encroachment, termination, renewal, fair dealing, advertising issues, etc. (Other than start-ups looking for anyone to be a franchisee.)

During the testimony, there were certain themes that were bantered about by the franchisor opponents. The themes ranged from government intervention in a business relationship, legislation would stop franchising, franchisees did not have a gun pointed to their heads to enter into the agreements, franchisees are barring franchisors from their ability to enforce standards, and legislation would do nothing but increase litigation. In response to each of these I state the following:

1. Government intervention in a business relationship. The government has a history of being involved in third party business relationships. As a matter of fact, the government has been involved in franchising, in particular dealing with the automotive and gasoline industry. The legislation concerning auto dealers and gas station owners has proved helpful to those related franchise industries, not detrimental.

2. If there is Federal legislation, franchising would forever stop. I believe that there are new car dealership franchises, gasoline station franchises and franchises within the various states that have enacted franchise laws, including Iowa. Whenever the Iowa legislation is debated, the theme conveyed by franchisors has always been that if the Iowa legislation were past, franchising would forever stop in Iowa. Contrary to the franchisor's statements, franchising continues in Iowa.

3. The franchisor has never placed a gun to the head of a franchisee requiring him or her to enter into the franchise arrangement. There are two aspects to the gun to the head proposition. First, as previously stated, in order to compete in many industries in America today, one must be a franchise. The franchisors in these industries know that and their franchise agreements are non-negotiable since there are no choices. In essence, there is a "gun to the head". Furthermore, the vast majority of franchise agreements contain a provision that state "upon expiration of the initial term, franchisee may renew for an additional term so long as he or she complies with a list of numerous requirements including and most importantly, the franchisee signing the then current form of franchise agreement. In other words, after the initial term of five, ten, fifteen or even twenty years, the franchisee who has devoted his or her full time and effort to growing that particular business and growing the brand recognition and having the franchisor profit from the franchisees, royalties and advertising contributions, must then either (i) *abandon* what he or she has worked for over those past five, ten, fifteen or twenty years or (ii) circum to the gun to the head and renew on the then current form of franchise agreement in order to protect his/her investment, which is typically in excess of $100,000 to $200,000. Also, what the franchisors neglect to tell you, is that if the franchisee does not renew, the franchisee is then subject to a restrictive covenant which would not all allow the franchisee to earn a living in the field that he or she has devoted him or herself to over the past five, ten, fifteen or twenty years. The franchisor is in essence denying the franchisee its right to earn a living for him or herself and their family. the franchisees have a gun to their head and are forced to sign whatever the franchisor puts before them.

4. Franchisors will not be able to enforce their standards. There is not a franchisee or a franchisee advocate that can honestly state that a franchisor should not have the right to enforce its standards. Standards are the crucial element of the franchise concept. A franchisor must be able to enforce its standards for the good of the franchisor, the franchise system and the franchisees. The objection of the franchisees is that the standards are unfair and unreasonable. They are *not* objecting to enforcement.

5. Litigation will increase. I know from experience that franchisees do *not* want additional litigation. As a matter of fact, and the franchisors know this, your typical franchisee cannot afford to hire my services or for that matter any other franchise

attorney to litigate against the deep pocket franchisor. The legislation is needed to define the boundaries of the franchisor's and franchisee's conduct. Defining the boundaries through legislation will allow the franchisor and franchisee to *amicably resolve* disputes more so than ever before since the franchisor currently has the upper hand against the typical franchisee.

6. During the testimony on June 24, 1999, a witness stated that franchising is a "partnership". That is a sales tool, unfortunately not the reality. In a partnership that means a win/win situation. However, in your typical franchising arrangement, the powers between the franchisor and franchisee are unequivocally lopsided toward the franchisor. As a matter of fact in a number of franchise agreements that I have personally reviewed, I have found statements that read "franchisee shall deal honestly and faithfully with the franchisor." *Nowhere*, however, do I find a reciprocal provision stating that the franchisor will deal honestly and faithfully with the franchisee. Why is that? Why is a franchisor asking the franchisee to deal honestly and faithfully, but the franchisor will not do the same with a franchisee? . . . Because the franchisor given the current state of affairs, do not have to.

7. A witness who testified concerning Mrs. Field's and Great American Cookie Company relationships indicated that when the Great American Cookie franchisee had a problem with the idea that Mrs. Field's would be buying Great American, the witness indicated that the two parties simply contacted one another, met at a table and resolved the issues. If my understanding of the situation involving Mrs. Field's and Great American Cookie Franchisees is correct, the Great American Cookie franchisee had to *first file a lawsuit* in order to get the attention of Mrs. Field's. Eventually, however, it seems that a resolution was found. But this franchisee had the resources to file a lawsuit to get the attention of the franchisor. This was not a simple franchisee calls franchisor to resolve such important issues, nor does the typical franchisee have the ability to file a lawsuit.

8. A witnesses testified that the "courts bend over backwards for franchisees." I, as a practicing attorney that gets involved with franchise dispute resolutions would like to know what jurisdiction he was referring to. I have yet to find a jurisdiction that "bends over backwards for franchisees".

As with anything to be debated, the discrepancies in one party's position verses the other could go on forever. The real issue is are franchisees in significant numbers being taken advantage of or abused (contractually) to which they have little or no current recourse>. The answer can be demonstrated from the hundreds and thousands of franchisees that have been hurt from the increasing phenomenon of franchising. The plight of the franchisees is not to gain an upper hand or to change the franchising industry. It is simply to allow the parties to deal with *each other* fairly. The pursuit here is for all involved to be part of the American dream and to be able to profit from the operation of a business. No one is suggesting that franchising is a guaranty to success. No one should be suggesting that one party should have the right to take advantage of the other. Unfortunately, history will show you that the franchisors in general have taken advantage of the franchisees. This is not your typical business relationship. A quick review of the franchise agreements will prove that this is not a typical business relationship. In some respects, the franchisee is nothing more than an indentured servant.

Again, not all franchisors are bad and not all franchisees are good, but when there is wide spread problems and issues for which there is no adequate recourse or remedy, the federal government needs to do its duty and protect the public, which includes franchisees.

I strongly recommend that the committee and Congress pursue this matter in depth so that all the facts are before you and I anticipate that you will see the need for federal legislation to protect franchisees and to insure that both parties, the franchisor and the franchisee will *both* deal *honestly and faithfully with each other*.

Thank you for the opportunity to be a part of the record. If you or any other member of Congress wishes to obtain additional information or comments, please do not hesitate to contact me.

Thank you.

Very truly yours,

HARRIS J. CHERNOW.

CHEM-DRY OF TENNESSEE,
*Hermitage, TN, June 30, 1999.*

Hon. HENRY J. HYDE, *Chairman,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR CHAIRMAN HYDE, CHAIRMAN GEKAS AND MEMBERS OF THE SUBCOMMITTEE: On 24 June 1999, we attended the House Judiciary Committee's Subcommittee on Commercial and Administrative Law. We ask that the following statement be included as part of the written record for the Oversight Hearing on franchising.

In 1986, we quit our jobs, sold our Reno, Nevada home and packed up kids, dog and every worthy good we owned to move sight unseen to Clarksville, Tennessee. We had purchased the first Chem-Dry carpet & upholstery cleaning franchise to operate in the state of Tennessee.

The minimum training we received from our franchisor did not adequately prepare us. We learned this hard lesson soon after plunging into the business world. Although our funds were limited, we paid thousands of dollars to attend schools to learn the carpet cleaning business.

We had made up our minds not to fail. We worked and sacrificed much to achieve success. Eight years would go by before we had a vacation. Our 16-year-old daughter worked after school to pay her own expenses and later to pay her college tuition. I remember so clearly one night while preparing dinner and she asked me, "Mommie, will we ever eat steak again?"

Every cent we made either went back into the business or for our children. We even had a foster daughter for a year that we loved with all our hearts. It was never easy but we persevered.

Now thirteen years later we have a comfortable life. Our daughter married a Clarksville boy and they have a 17-month old daughter. Both of them work full-time for us. Our 23 year-old son also works for us full-time and we have a manager in Clarksville who has been with our company since 1990.

The franchise agreement we signed in October 1986 was nothing like the agreements we have subsequently been forced to sign since then. In 1986, there was no gun to our heads to make us sign. Our contracts are renewed every five years and every five years the franchisor gains more control and makes more demands. They can pick and choose what part of the contract they want to enforce and choose the franchises' they want to harass.

Our franchisor has forced its franchisees to purchase inferior equipment at inflated prices.

Our franchisor can amend any part of the contract by simply stating the change in the franchisee newsletter.

Our franchisor has doubled the amount of chemicals franchisees must now purchase.

After working hard establishing our business, if we refuse to sign the current contract we must give up our telephone numbers, client list and not compete for a period of three years. You see we are forced to sign the new contracts or get out of the carpet cleaning business all together. This is the business we as a family know and take great pride in. The franchisor now has the proverbial gun to our heads and the safety is off and the pin is ready to fall.

The non-compete clause does not allow us to become an independent business owner. This covenant has the effect of appropriating to the franchisor all of the equity and goodwill we have built up over the years. We need to preserve our "sweat equity" and be allowed to become an independent business.

This is a "family" business . . . a small business. The horrid stories we have learned from other franchisees are abominable. Franchisors are literally choking their franchisees. Unfortunately most franchisees are scared to death to challenge their franchisor for they have also heard all the horrid stories.

Franchisees are at the mercy of the franchisor. In a Chem-Dry Newsletter dated August 1997, the then President and CEO called those of us who were calling for changes, "Self-appointed angels of despair", "boomer doomers" and compared us to Hitler, Saddam Hussein and the Ayatollah.

My husband and I want to leave our business to our children. With the present contracts we can not. This is no longer "our business" . . . we are just renting it from our franchisor.

Please be assure we are not simply a disgruntled, unsuccessful franchise asking the government to intervene on our behalf. For the past 13 years we have been a franchise in excellent standing. Our bills have always been paid on time. We have never violated the boundaries set forth by the franchisor, yet we have our exclusive areas (which we pay a monthly franchise fee for) infiltrated by competing Chem-Dry franchises. The franchisor has done little to alleviate this problem.

Franchise venue provisions require disputes to be litigated or arbitrated in the home state of the franchisor. In our case, we would have to go to the state of Utah. This not only increases cost for us but also allows the franchisor to litigate or arbitrate on their home turf.

The founders of Chem-Dry are of the Mormon faith. How could a Southern Baptist man and his Roman Catholic wife ever conceivably win a fair judgment in Salt Lake City, Utah?

We are successful due to our hard work, customer service, dependability and fair prices. Thousands of our repeat customers call us because of Steve, Shirlee, Terry, David, Aaron and Cynthia and not because it is a Chem-Dry franchise.

Our franchisor can have their name, their trade secrets, their trademarks. We want the freedom to continue our livelihood in our way.

Thank you, Chairman Hyde, Chairman Gekas and distinguished members of this subcommittee for allowing us the privilege of submitting this statement. It is our hope that the subcommittee will expeditiously move to refine this legislation and forward it to the Judiciary Committee for further hearings.

If we may be of any further assistance, please call upon us.

Sincerely,

STEVEN L. SMITH, SHIRLEE FREUDEMAN-SMITH,
*Chem-Dry of Tennessee*

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## PREPARED STATEMENT OF BASKIN-ROBBINS INCORPORATED

Baskin-Robbins Incorporated appreciates the opportunity to submit these written remarks for the record of the Committee's Oversight Hearing on Franchising. As the Committee Members are no doubt aware, Baskin-Robbins is a franchisor of ice cream stores throughout the country. As such, we provide valuable opportunities to entrepreneurs seeking to run their own retail business, while also providing high quality ice cream and ice cream products to the public. Baskin-Robbins is concerned that the testimony provided by Patrick Leddy, Jr. to the Committee on June 24, 1999 disserves the Committee's purpose because it is inaccurate in several significant respects. First, Mr. Leddy failed to inform the Committee that the Franchise Agreement he signed does not provide him with any territorial rights. To the contrary, the Franchise Agreement provides Baskin-Robbins the discretion to open new stores where it determines a market exists. In Baskin-Robbins' experience, this discretion is *critical* to build brand recognition and make our stores more convenient to the customer. In fact, it is a well-established principle in our industry that increasing the number of stores in a market increases brand recognition and demand, ultimately helping the sales of all of the franchisees in the system.

Second, you should be aware that prior to authorizing the opening of the Valencia store referred to in Mr. Leddy's remarks, Basin-Robbins followed its established proximity policy to address the potential impact the new store might have on Mr. Leddy's business and we shared the results of the study with him. Baskin-Robbins' proximity policy endeavors to site new stores so that there is no material, sustained adverse impact. If there is impact, we explore a variety of measures to counter it. We have placed thousands of stores and rarely receive a complaint. If, however, there is a complaint, we follow our policy to seek a resolution. Thus, Baskin-Robbins has been—and continues to be—willing to work with Mr. Leddy pursuant to our internal proximity policy for addressing instances in which a franchise experiences a sustained adverse impact to its sales.

Third, you should also be aware that Baskin-Robbins, although not required to do so, offered to purchase Mr. Leddy's store at fair market value. Unfortunately, Mr. Leddy was seeking a price that was almost 100 percent higher than another Baskin-Robbins for sale in the same area at that time, which made consummating the transaction impossible.

Finally, Mr. Leddy's suggestion that Baskin-Robbins has brought a lawsuit against him improperly is completely false. Baskin-Robbins was forced to sue Mr. Leddy to gain his compliance with established health, sanitation, and safety standards designed to protect the public. Despite notice and ample opportunity to cure, Mr. Leddy failed to correct numerous health and sanitation violations at his store. In return, Mr. Leddy has sued Baskin-Robbins attacking its entire system of standards enforcement.

Mr. Leddy's testimony that Baskin-Robbins has acted out of hostility toward him or in disregard for the impact that the opening the Valencia store would have on him is belied by the record. Baskin-Robbins has strictly adhered to its proximity policy, which is designed to avoid adversely effecting existing stores and, when an adverse impact is demonstrated, providing assistance to the effected franchisee. Moreover, when Mr. Leddy expressed an interest in leaving the system, Baskin-Robbins offered several methods of assistance to him, including offering to purchase his store at fair market value. To date, he has chosen not to take advantage of these opportunities.

In conclusion, Baskin-Robbins submits that existing laws and policies, like its proximity policy, when followed by the franchisor *and the franchisee*, can effectively address situations such as Mr. Leddy's without the need for new legislation or regulations.

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LODGING HOSPITALITY SYSTEMS, INC. (LHS),
GOVERNMENT AFFAIRS COMMITTEE,
ASIAN AMERICAN HOTEL OWNERS ASSOCIATION (AAHOA),
*July 1, 1999.*

SUSAN JENSEN-CONKLIN, *Counsel,*
*Subcommittee on Commercial and*
*Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

RE: June 24, 1999 Oversight Hearing on Franchising

We submit this testimony to be included as part of the written record regarding the above-named hearing.

The Asian American Hotel Owners Association (AAHOA) is very familiar with the issues and concerns discussed at the June 24 1h hearing. We are a trade association of more than 4,500 members who own both independent and franchised hotel properties in every state in the country.

The proposed legislation, last year's Coble-Conyers bill, would set minimum standards of conduct for both franchisors and franchisees to abide by like a duty of good faith in the performance and enforcement of the franchise contract. Who in their right mind can possibly oppose dealing in good faith?

Unfortunately, however, too often franchisor lawyers have loaded up their clients' franchise agreements with every pro-franchisor paragraph they can think of . . . to the detriment of the business relationship formed by that contract. Often times franchisor staff are appalled once they are actually shown the types of provisions that are buried in their company's franchise agreement. They have not had to deal with the fine print in the agreement to determine if it is really a reflection of their company's policies and if it is truly how they want to treat their partners, their franchisees. In fact, Robert Hazard, an ex-CEO of a very large hotel franchise chain recently concluded in an article he wrote for the June issue of *Franchise Times* that as a franchisee today he would have trouble signing the very agreements he once stood behind as CEO.

Let me give you just two examples to illustrate the current state of the one-sidedness and asymmetry of rights in the franchise relationship. First, a friend of mine who also happens to be a franchise attorney recalled a recent legal symposium he attended. One of the workshop sessions he attended was on the subject of "encroachment" which many franchisors, to mask the reality of what actually happens, insist on calling 64systern expansion."

At the start of the presentation, one of the speakers, in an effort to lead with humor said substantially as follows: "in planning for this presentation, we thought we might use a title like, *How To Put a New Unit Up Across the Street from Your Franchisee and Get Away With It*, but we decided that would be a bit obvious. Instead, we decided to use the title, *System Expansion*." The attorneys in the room who primarily represented franchisors were laughing; the attorneys in the room who primarily represented franchisees were not. If you agree with comedian Alan King who once said that the root of all great humor is truth, you understand the seriousness of the imbalance between the two parties to a franchise.

Second, at the same legal symposium, the general counsel for one of the country's largest franchisors, in response to a discussion question about the wisdom and impact of the then-recently issued Scheck decision made his views on encroachment very clear, and I'm paraphrasing, "No judge, federal or state, was going to tell him where he could or could not develop a unit." The arrogance of that remark and the gross imbalance of legal and economic power in the franchise relationship point to the urgent need for meaningful change through federal standards of conduct.

My family owns franchises with several different hotel brands. Because the agreements I now have with these brands are so one-sided I decided to start my own lodging franchise chain, Lodging Hospitality Systems, Inc. (LHS). However, the non-compete clauses and other legal devices in current contracts make it almost impossible for franchisees to get out of their current one-sided agreements to join my now system. Our franchise agreement with our franchisees is probably the most equitable in the entire lodging industry. More franchisors could do what we do, but they Won't do so voluntarily.

Obviously, I strongly support the introduction, consideration and passage of legislation similar to the Coble-Conyers bill introduced last Congress to set minimum standards of conduct and to level the playing field between franchisors and franchisees. This is long overdue.

More importantly, AAHOA strongly supports the introduction, consideration and passage of legislation similar to the Coble-Conyers bill introduced last Congress. AAHOA members have been working towards this result for many years low. In 1995 members of AAHOA were elected as delegates to the White House Conference on Small Business (WHCSB). We worked side-by-side with other franchisees and small business people to ensure that the issue of franchisee legal and constitutional rights was a priority issue among all of the concerns of small business owners. Franchisee issues and concerns, much like those presented at the June 24th hearing were part of the final WHCSB agenda as an important item to be brought to the attention of the President and Congress.

The Asian American Hotel Owners Association (AAHOA) is in favor of legislation like Coble-Conyers because it would restore freedom to contract for small business people who buy franchises. We are available to work with the Committee toward that end. Thank you for the opportunity to present our viewpoints.

If you have any questions, please feel free to call me.

Sincerely,

JAY S. PATEL, *CHA President/CEO.*

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PERRY, PERRY & PERRY,
ATTORNEYS AT LAW,
*Minneapolis, MN, July 2, 1999.*

MS. SUSAN JENSEN-CONKLIN, *Counsel,*
*Subcommittee on Commercial and*
*Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

Re: HR 4841

DEAR MS. JENSEN-CONKLIN: I respectfully request that this letter be included as part of the written record for the June 24, 1999 oversight hearing on franchising.

I have been active in franchise litigation and have represented many franchisees who typically are small business owners with limited resources.

I am writing to provide my views on the contention of opponents of the Bill that HR 4841 would lead to increased franchise litigation. It is my opinion that it will actually result in less litigation. Because the current typical franchise agreement is presented to a franchisee on a "take it or leave it" basis with virtually all of the rights slanted in favor of franchisors, if anything goes wrong with the business that causes franchisees to become delinquent in their payments, the franchisors typically initiate collection lawsuits. This is true even if the conduct of the franchisor was responsible for the franchisees inability to pay its bills. Examples include:

1. Requirements that franchisees must purchase their products from the franchisor even if above competitive costs;
2. A franchisor opening a new company owned store or franchised outlet in the trade area of the franchisee which cannibalizes its sales; or
3. Mis-management of a national advertising fund that franchises are required to contribute to.

These are three examples of the inequities HR 4841 is intended to remedy. Without the protections afforded by the Bill, franchisors are generally free to engage in such conduct no matter how harmful it is to the franchisees. Franchisees rarely prevail on such claims in Court and can be ruined financially from such conduct with no effective remedy. Because franchisors have such powerful rights under typical franchise agreements, they have very little incentive to negotiate with franchisees and routinely bring collection cases as a result. Invariably, franchisees assert counterclaims, but rarely prevail in court.

If franchisees had potent legal remedies such as those in HR 4841, franchisors would have a much stronger incentive to avoid injuring franchisees and would also have a strong incentive to negotiate rather than litigate. In short, the presence of more balanced rights should *decrease* the amount of litigation while at the same time protecting small businesses from onerous contracts and conduct.

Very truly yours,

SHAWN M. PERRY.

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LAW OFFICE OF
MARC N. BLUMENTHAL,
*Chicago, IL, July 2, 1999.*

SUSAN JENSEN-CONKLIN, *Counsel,*
*Subcommittee on Commercial and Administrative Law,*
*Committee on the Judiciary,*
*House of Representatives, Washington, DC.*

DEAR MS. JENSEN-CONKLIN: Please include this letter as part of the written record for the June 24, 1999 oversight hearing on franchising, conducted by the committee. I am a franchise lawyer with almost eighteen years experience. I have served both as in-house counsel and in private practice. I represent franchisees and start-up franchisors. I am familiar with and wholly support HR 4841. It is legislation whose time is way overdue for the following reasons:

1. Encroachment can be deadly. Encroachment, often without regard to the existing franchisee has cost numerous franchisees minimally, profits, but, more often, their investment and their franchise. This is a two prong problem, since it pits the franchisor against the franchisee and the franchisee against the incoming franchisee, who aligns (at the beginning) with the franchisor, who granted the franchise. This creates an unpleasant, if not, impossible work environment, and cause fractures within the franchisee network. Instead of relying on each other for support and brand exposure, one franchisee takes business from the other, or may put the other out of business. Many states have laws to protect the formation of associations. Think about how easy it would be for franchisees to form associations when they are literally at each other's throats. The other side of the coin is the franchisor may be making slightly more money because a larger market is tapped, while the existing franchisee suffers. Eventually, the encroaching franchisee will also suffer. Without legislation, nothing will stop franchisors from continuing to justify encroachment thus weakening existing franchisees.

2. Transfer. Transfer must be permitted, within reason. Franchise Agreements which state the franchisor has unfettered discretion and can deny a transfer for any reason, or worse, unreasonably withhold approval must be outlawed. This type of provision permits a franchisor to be vengeful, to make life very difficult and to determine, not once, but each time a qualified candidate is presented that no transfer will take place. This practice must be brought to a halt as quickly as possible. Within the bounds of acceptable reason, language can be drafted to allow a transfer, while maintaining the franchisor's standards. With such legislation, franchisors, would be unable to punish a franchisee, thus depriving the franchisee of realizing appreciation for the investment, or simply getting out of a bad situation. Bad transfer provisions can affect both the poor operator, as well as the stellar operator.

3. Franchisor's Lament. Franchisors claim no one held a gun to the franchisee's head. They are right. Yet, there are events throughout the term of the franchise which franchisees can, in no way, control. Three events which immediately come to mind are unilateral changes in operating manuals, which effectively alter the franchise agreement. These changes could cost the franchisee money, the franchisee did not intend to invest, could change a means of supply on which the franchisee depended, could remove a product, and so on. The changes could come about at renewal when the franchisee has almost no choice but to sign the then current agreement, (or give away the business). The current agreement in all likelihood will be tougher, and maybe more costly than the first. They could also come about at time of transfer, when the franchisee is required to sign one document or another which may foreclose the franchise from ever taking action against the franchisor. The gun to the head is a feeble attempt at saying no one told you to get in. However, the once your in part is the part we in the franchisee lawyer community are much more concerned about, since we can advise against getting into a bad deal: Its tougher

to advise how to get out. Many good deals have a way of going bad, when pertinent things change during the term of the franchise.

4. Decrease Unnecessary and Cost Prohibitive Litigation. Litigation, or worse arbitration, currently the bailiwick of the franchisor, will undoubtedly decrease because franchisors, will have guidelines on how to conduct business, guidelines which do not exist today. The proposed law will set a framework for a more amiable relationship, but, will provide franchisees a way to seek redress, they do not have now, if the franchisor transgresses. The expense of litigation for both parties will decrease, since franchisee lawyers won't be shooting in the wind, constantly inventing theories just to justify the most egregious behavior. Both sides will know the law, and hopefully obey it.

5. Duty of Good Faith. It is astonishing that there currently exists no duty of good faith and fair dealing in the franchise realm. This is basic. Given the large sums of money both paid to franchisor at the outset and through ad funds and royalties, one wonders how something as elementary as good faith has not been included. To deal with a party in anything other than good faith raises the specter that one is dealing in bad faith. Relationships based on bad faith are not relationships, they are situations where one party intentionally takes advantage of the other, for pecuniary gain, or other. Franchising must be about cooperation. Cooperation begins with respect, and the duty of good faith and fair dealing is absolutely essential if there is to be respect. In the franchise agreements I write, I include the following clause:

> "Each party to this Agreement agrees to treat the other in a fair and equitable manner, and in all transactions, interactions and disputes to negotiate and to deal in good faith."

To state that a federal requirement imposing a duty of good faith will cause irrevocable damage is pure folly. This type of statement should make the legislators wonder with whom they are dealing, and the basis for the opposition, if franchisors are not willing to adhere to a good faith standard.

6. Association. Franchisees must have the unfettered right to associate, and to form associations for many reasons. The proposed legislation permits that right. Many states have recognized the need for free association and have legislated it into their various franchise statutes. It must be a federal right as well.

Nobody believes that the proposed legislation will be a panacea, nor will it make all franchisees successful. It will help. There is no question but that my clients will benefit from the proposed legislation, and I urge its passage as quickly as possible.

Thank you for this opportunity to express some of my views on the subject.

Very truly yours,

MARC N. BLUMENTHAL

-----Original Message-----
From: Howard E. Bundy [SMTP:bundy@bundymorrill.com]
Sent: Friday, July 02, 1999 8:30 PM
To: Jensen-Conklin, Susan
Subject: Franchise Legislation

Ms. Jensen-Conklin:

Please add these brief comments to the official record of the House Judiciary Committee's Subcommittee on Commercial and Administrative Law--during the extension of the June 24, 1999 hearing.

I am an attorney in Seattle, Washington. I have been practicing law since 1981. My practice is primarily devoted to franchising. Although the vast majority of my clients are franchisees, I also do contract and regulatory compliance work for a significant number of start-up franchisors. Thus, I have a somewhat unique understanding of the issues and concerns of both franchisors and franchisees.

I will leave analysis of the details of any particular version of potential or past legislation to either a later time or to those more familiar with the details.

Where I believe I can add value to the committee at this time is with regard to the effect of remedial legislation upon the amount of litigation. The State of Washington has had the Washington Franchise Investment Protection Act since 1972 (Wash. Rev. Code Chapter 19.100), which includes registration and disclosure requirements, anti-fraud sections and a relationship section. The relationship section contains, among other things, a general obligation of the parties to act in good faith, an anti-discrimination provision, a provision that prohibits unfair and unreasonable terms and conditions, and restrictions on termination and non-renewal.

There are less than 25 reported appellate cases in Washington under the Washington Franchise Act. The existence of the statute has not generated a significant increase in litigation. The vast majority of the cases we bring on behalf of franchisees involve claims of failure to comply with the registration and disclosure provisions of the Act and violation of the anti-fraud provisions, including giving illegal earnings claims. Although we have brought relationship claims, they tend to be obvious violations such as opening a competitive store of the same brand within 100 yards of the franchisee's store and materially impacting the franchisee's sales and profits.

The risk of excess litigation in these matters tends to be self-policing. By the time they consult with us, most franchisees have lost their entire life savings and have little resources to pursue the valid claims they have. Virtually every case has an overwhelming economic component that drives a lot of strategic decisions. When an attorney is agreeing to invest substantial time and resources in a case on a contingent fee basis, the attorney is highly motivated to make an early determination that (a) the case is strong on the merits that would lead to liability and (b) the case has sufficient economic value to justify the effort. Courts and arbitrators have a difficult time enforcing remedial statutes protecting small business people. Those of us "in the trenches" who litigate these cases cannot afford to take many cases that someone later might find to be "frivolous". In almost 18 years of litigating for franchisees, I have never had a judge or arbitrator even suggest that my case was frivolous.

An argument often made against relationship legislation is that "no one held a gun to the franchisee's head--he/she voluntarily signed the contract". The argument belies reality. Any person who wants to enter a business today and use a "national" or "major" brand in connection with their business must sign a franchise agreement. Franchise agreements have become largely standardized--particularly within industries--so franchisees really do not have the option of a different type of contract. Even more so, upon the expiration of the initial term, the franchisee is subject to the franchisor's whims. The franchisee will, in most cases, be subject to an agreement not to compete after the contract expires or terminates. Thus, at renewal, the franchisee must often choose between starting a new career in another industry and giving up the goodwill he/she has built over three to ten years or signing the franchisor's new form of contract--which often removes the original territorial protections, obligates him to spend a lot of money on modernizing the business to comply with the franchisor's new image, and imposing new or higher fees and new rules and regulations. Franchisees need protection from such unilateral modifications of the franchise relationship in the middle of the realistic life of the business.

In virtually every case, the first defense the franchisor's attorneys raise is that the franchisee is incompetent or failed to "follow the system". I understand that this specter of the "disgruntled unsuccessful operator" has been raised before the committee. There probably are isolated instances of such incompetence. However, there are many more instances where the real suspect is the franchisor's selection process combined with a very weak training program. We have heard many many stories and seen substantial evidence in many cases of franchisors who would sell to anyone who can fog a mirror and has a little bit of cash. In fact, one of the purported advantages of franchising in many cases is that "you don't need prior experience in the _______ industry." The franchisor then puts the franchisee through a five to ten day training program that is little more than a pep rally broken up with sessions on how to properly fill out the reports so that the franchisor gets paid every dime they are entitled to under the contract. It is a rare franchisor, by our experience, that really trains its franchisees in the practical, day-to-day operation of the business. Much is promised--little is delivered.

Washington franchisees who fall victims to the investment abuses of some franchisors are luckier than most. They have a state statute that provides them with a private right of action. The other franchisees across the country deserve at least the same protection.

Franchisees, generally, tend to be very small business people. Rarely do our clients have a net worth of more than about $100,000--at the time they invest in the franchise. Seldom do they have prior business experience and rarely do they have prior experience in their new industry. Most do not have a relationship with an attorney or an accountant before they purchase. Most never consult with an attorney or accountant about the investment decision--being encouraged to believe that it is an unnecessary expenditure of funds--and that attorneys are just "deal killers". They make the decision on the same basis that first time car buyers buy cars and in an atmosphere that would make the sellers of timeshares look like angels. They buy based upon the "sizzle" and the promise that they can make a lot of money and have a lot of support and training in operating the business--without having a yardstick to measure those promises against. They pay more than the cost of obtaining a masters degree and get less than a month of "training" and the right to use a trademark that usually is largely unknown to their prospective customers. These are not sophisticated business people--even if they are "retired" from major corporations. Generally, the franchise agreement is the first major contract they have ever personally faced and they assume it is "standard" and that they will be treated fairly by their new "partner".

Regrettably, in many cases, nothing could be further from the truth. After the franchisor gets the money, the promises evaporate and the focus moves on to selling the next franchise rather than on helping the franchisee survive and succeed. Indeed, the economic incentive for many franchisors favors a large failure rate so that they can re-sell the territory several times and realize more franchise fees.

Perhaps not all of these and other offenses to fairness can be fully addressed through legislation. However, the committee needs to be aware that such abuses exist. They need to understand that franchisors come into the relationship with a significant advantage in terms of information and legal talent. They need to understand the manner in which the stronger party can manipulate and change the contract terms over time.

I urge the committee to conduct a thorough study of the problems and deficiencies of the franchise industry. Many constituents are being harmed, losing their life savings, their retirement reserves and their independence--in many cases through an ultimate bankruptcy because of the rampant abuses in the industry. Without some remediation on some level, investors will continue to be harmed and franchising as a way of distributing goods and services will decline into disrepute. In order to save franchising and those who would enter into businesses under recognized trade names, someone--probably Congress--must level the playing field. Someone must make sure that there are the same type and quality of protections for those who invest in franchises as for those who invest in stocks, or time shares or for consumers who invest in cars, homes and certain other major assets. Full presale disclosure of material facts and fairness in the relationship should be the hallmarks of any legislation.

Thank you for the opportunity to comment. Please do not hesitate to contact me if I may assist the committee or the staff in any manner.

Sincerely,

Howard E. Bundy
BUNDY & MORRILL, INC., P.S.
bundy@bundymorrill.com
12351 Lake City Way NE, Suite 202
Seattle, WA 98125-5437

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PREPARED STATEMENT OF JEFFERY S. HAFF, DADY & GARNER, P.A., MINNEAPOLIS, MN

I respectfully request that this letter be included in as part of the written record for the June 249 1999 oversight hearing on franchising.

As an attorney whose practice is concentrated on protecting the interests of franchisees, big and small, successful and not, I am not surprised to read the doomsday predictions of franchisor advocates who claim that if the bipartisan Small Business Franchise Act of 1998 is enacted in its current form "new franchising activity is likely to stop stone cold" and the Act will create "an environment that fosters constant litigation." After his many years of walking on the franchisors' side of the street, I am sure these folks believe what they say. However, I believe that there is good reason to conclude that if the proposed legislation is passed (1) constant litigation will *not* ensue, and (2) franchising will not end. Furthermore, I believe that franchisors, by their past conduct, have brought about the very legislation they now fear.

As a franchisee lawyer in Minnesota, I reside in a state with one of the nation's best pieces of pro-franchisee legislation, the Minnesota Franchise Act (the "MFA"). The MFA, in place since 1973, protects franchisees against numerous acts by a franchisor, including: (1) failure to register in the state, (2) failure to properly disclose information about the franchise, (3) false or misleading oral or written statements, (4) termination of a franchisee for other than good cause, and (5) termination of a franchisee without proper notice and opportunity to cure any perceived deficiency of performance. The Minnesota Commissioner of Commerce has also enacted specific rules defining other things a franchisor cannot do. For example, one rule says that a franchisor cannot impose upon the franchisee any "unreasonable" standard of conduct. Very broad language indeed.

Despite the MFA's many protections (which franchisor advocates no doubt believe "disrespect" the "sanctity of contract" and "ignore the legitimate interests of franchisors"), franchising continues to flourish in Minnesota. The Minnesota courts are not unduly burdened with franchise disputes; in fact, despite my firm's Minnesota address, over 80% of our work involves disputes having no connection to Minnesota. I believe this is due, at least in part, to the fact that franchisors who know they are legally obligated to act reasonably actually *try* to act reasonably. By doing so, they give franchisees less to complain about. If a franchisee is treated reasonably, what reason does s/he have to sue?

The recent parade of horribles offered up by franchisor advocates is nothing more than a rephrasing of their constant refrain of old that *anything* helpful to franchisees will "kill the goose that laid (or "lays," depending on which article you read) the golden egg. "According to franchisor advocates, the franchising "goose" is a very weak animal so susceptible to fatal injury that one has to wonder how it has survived as long as it has. These franchisor advocates have long claimed that any new state franchise legislation will kill the goose, as will any court decision that says a franchisor has to act reasonably or honestly, as will any effort by franchisees to "collectively bargain" the terms of a franchise agreement, as will granting a private right of action to franchisees under the FTC Rule, as will the Small Business Administration requiring that the franchise loans it guarantees be loans to franchisees whose franchise agreements cannot be terminated without cause. I suggest that there is no more reason to compare franchising to a fragile goose about to take a terminal turn than there is to believe that geese actually lay golden eggs.

Before debating the merits of the proposed legislation, we should ask ourselves why it ever came to be introduced. I suggest that the refusal of franchisors and their advocates to even *try* to be fair to franchisees is why franchisors are where they are today, scared to death of federal legislation. What fair-minded person likes to hear stories of franchisees given inflated earnings claims, encroached upon, terminated for no good reason, forced out of business and denied the right to negotiate even one term of the boilerplate agreement presented to them. And the fact of the matter is that the stories sound even worse when the franchisor ultimately goes into court and successfully argues that had the franchisor planned on acting reasonably, it would have said so *in writing*! These same non-negotiable franchise contracts are re-drafted every year to take more and more rights away from franchisees. Many long-term, successful franchisees are now facing the wonderful choice of (1) "renewing" their expiring contracts on terms that are so one-sided they shock the conscience, or (2) going out of business. Is it any wonder that these folks turn somewhere for help?

Franchisor advocates now seek less comprehensive measures to address franchisee concerns. The short answer to that request should be, "Sorry, too late. "For years, efforts to help franchisees have been quashed by franchisor resistance. Franchisor advocates have long opposed a private right of action under the FTC Rule or collective bargaining of franchise agreements. Franchisors have refused to negotiate individual contract terms, tried to circumvent state protective statutes by contract provisions, and consistently reserved the right to act "unreasonably" or "in the franchisor's unfettered discretion. "Franchisors have been intransigent for too long. Congress should exercise its discretion to move the franchisor flock where they should have voluntarily traveled—to a place where franchisors and franchisees deal with each other honestly, fairly, and in a commercially reasonable manner. What's so wrong with that?

I am aware of two themes that have been advanced against the litigation that I would like to specifically debunk: (1) the claim that only unsuccessful franchisees want this legislation, and (2) the claim that a franchise contract is negotiable. First, successful franchisees often "build the market" for a brand when neither other franchisees nor company-owned stores could. The "reward" for that franchisee is often that s/he gets the market stolen from them by the franchisor. A successful franchisee is probably more likely to be encroached upon ("If he's doing that well he won't miss a little business.") and, ironically, may be at least as likely as a poorly performing franchisee to not be renewed at the end of the franchise agreement ("We'll just go in and take his profit; he cannot compete with us due to his covenant not to compete."). As Darrell Dunafon has testified, successful franchisees also may attempt to make things better for other franchisees and thus incur the wrath of the franchisor. Successful franchisees are probably the group of franchisees *most* in need of protection from encroachment, non-renewal without cause, covenants against competition, and efforts to quash free association Struggling franchisees will rarely last long enough to worry about most of these issues.

The claim that franchise agreements are negotiable is laughable. Most franchisors simply present the document to the franchisee and say, "If you want the pot of gold, sign the document. "Perhaps the best example of a prospective franchisee's lack of options is the recent quote of Thomas Gunderson, Vice President of Franchising at Express Personnel Services in the 2nd Quarter 1999 edition of *Franchise Update*, talking about how he weeds out unacceptable franchisee candidates

> One roadblock Gunderson always watches for discovery day is the prospect who wants to negotiate the royalty, the territory or the terms. "That's the kiss of death. There's no negotiation here. Everybody is on the same deal."

*Franchise Update*, 2d Quarter 1999, p. 16.

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[*Note:* On file with the Subcommittee on Commercial and Administration Law of the House Committee on the Judiciary are the following materials:

"The profile of Franchising" Volume II: A Statistical Profile of the 1997 Uniform Franchise Offering Circular (UFOC) Data. Prepared by: Frandata Corporation, Washington, D.C. and The College of Business and Public Administration, University of Missouri-Columbia, Columbia, Missouri.

Restaurant Finance Monitor, Volume 11, Number 5, May 24, 1999.

International Franchise Association, Education Foundation, National Franchise Owner Study, The Gallup Organization, Lincoln, Nebraska.

Karp, Eric H. Esq., "Holding a Gun to Your Head: Marketplace Monopoly-How Pizza Franchisors Play the Game" American Franchisee Association, 1999 Franchisee Legal Symposium, May 6–7, 1999, Hilton Head, North Carolina.

McElgunn, Christopher A., "The Bunker Shot: Can Franchisees Extricate Themselves from Being Forced to Purchase Supplies For Their Franchisor?" American Franchisee Association, 1999 Franchisee Legal Symposium, May 6–7, 1999, Hilton Head, South Carolina.

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